"The authors offer the experienced and novice trader alike valuable insight found nowhere else."

Traders World Magazine

"Koppel and Abell have delivered a clearly written, entertaining guide for traders who aspire to improve their performance and achieve a 'world class' stature . . . I believe *The Innergame of Trading* makes an important contribution."

Moe Daniel
MTA Book Review

"Destined to be a trading classic, there has never been a book like it. *The Innergame of Trading* combines amazing insights from top traders with a step-by-step program to develop the behaviors and inner psychology that are necessary for trading success . . . this is by far the best book we have seen in 1994!

Dave Caplan
Opportunities in Options

"*The Innergame of Trading* is one of the best I've read. The methodical and nearly 'scientific' procedures the authors use to allow the trader to discover weaknesses and soft spots on the road to new focus and success are invaluable.

Robert B. McCurtain, Director of Technical Research
Ried, Thunberg & Co., Inc.
MTA Newsletter

"*The Innergame of Trading* is thought provoking . . . there are all kinds of useful nuggets in this book.

R.E. McMaster, Jr.
The Reaper

"If you want to improve your trading *The Innergame of Trading* is the book for you. I heartily recommend it.

Douglas P. Sooley, Publisher
Intraday Dynamics

The Outer Game of TRADING

Modeling the Trading Strategies of Today's Market Wizards

Robert Koppel ■ Howard Abell

PROBUS PUBLISHING
Chicago, Illinois
Cambridge, England

Contents

Foreword

by Jack Sandner
Chairman, Chicago Mercantile Exchange

I didn't set out to be a trader. In fact, had it not been for the late E.B. Harris, longtime president of the Chicago Mercantile Exchange, I probably would still be practicing law, not knowing very much more than the average person about either the Merc or trading futures and options. Harris lured me over to the exchange for a visit back in 1971, almost immediately after I had finished representing his wife. Apparently he was impressed with how I had handled myself in the trial, so when he congratulated me he said, "You've got to see the Merc." Once I did see it, once I had witnessed firsthand the excitement and the raw energy of the trading floor, I was completely sold on it and have been here ever since.

Having been a trial lawyer, I was used to hard work and long hours of preparation. Still, when I first walked onto the Merc's floor, I was a complete neophyte insofar as trading was concerned. In this new business, I had no role models to speak of, because, after all, I wasn't born into this industry and I didn't really have any friends on the floor to guide me. Nor were there any really effective books available back then that sized up what it takes to be a trader and how one goes about trading. So all I could do was rely on instincts honed in boxing rings and courtrooms, as well as watch the other traders with an eye toward identifying a role model or two. On the latter score, I am fortunate to have picked the right ones.

Twenty-three years later, I would still recommend that approach, because it seems to me that Yogi Berra was exactly right about how much "you can observe just by watching." But if I were a young trader just starting out in 1994, or even a not-so-young trader, I would also make it a point to read this volume and its predecessor, *The Innergame of Trading*.

In their first effort, published earlier this year, Robert Koppel and Howard Abell, took the inner psyche of the successful trader and placed it under a microscope, to great effect: What sets the great ones apart from the rest? What exactly are their beliefs? What mental strategies do they employ? What sort of internal dialogues do they engage in? What, in the end, makes them tick? Now Koppel and Abell are back with a comprehensive look at yet another part of the puzzle, focusing, in this book, on the very best traders' modi operandi, in terms of the goals they set and the exacting strategies they employ to reach them. As in their previous work, much of the material comes from extensive firsthand interviews with top traders, including Pat Arbor, Tony Saliba, Jeff Silverman, and Don Sliter.

There is, of course, no single path to success as a trader, yet, as this book makes clear, the really outstanding traders do share a number of traits. For example, they tend to be optimistic, and all happen to like what they're doing—a point that should seem obvious, but isn't necessarily. They are neither overly emotional nor temperamental. They are, in fact, relentlessly patient. They are able to accept losing as part of the process and know precisely when to cut their losses. They are never unprepared and always disciplined.

Some folks think traders have a nice life based on the misbegotten notion that they breeze in at about 8:30 in the morning and are out the door and on the golf course or wherever by 1:00 or 2:00 in the afternoon. What they don't realize is how much happens before and after the opening and closing bells. Just as any trial lawyer worth his or her salt devotes many, many hours to preparation and strategy, so does any really good trader. Preparing for those crucial hours on the floor entails an incredible amount of homework: no chart is ignored, no statistic, however esoteric it may seem, is discounted. Next, a precise strategy for the next day's trading must be mapped. That strategy must be so thorough that it will get the trader into the market at exactly the right point, define the trader's risk, and take the trader out at just the precise moment. Once on the floor, it should all be a matter of focus and execution.

In this volume, Koppel and Abell have, perhaps for the first time in one place, outlined what they consider the 15 essential elements of any successful trading strategy, everything from creating a point of focus, allowing for patience, and trading in a resourceful state of mind, to leaving no uncertainty and identifying opportunities. In addition, they have outlined a number of the classic strategies employed by successful traders, discussing at some length the choosing of a suitable one.

In trading, as in life, there are no sure things. Still, a host of opportunities await the individual equipped to recognize and exploit them. That is where *The Outer Game of Trading* comes in. It's an indispensable primer that, once read and digested, can put one solidly in the position to make the informed, split-second decisions on which day-to-day success in the trading of futures and options must in the end be based.

Preface

"A man who carries a cat by the tail learns something he can learn in no other way."

Mark Twain

The premise behind *The Outer Game of Trading* is a simple one: no trading system is perfect; however, the use of one is critical for trading success; and in order for a trading system to be successful it must be profitable, consistent, and personal. In other words, it must be guided by an overriding and all-encompassing trading strategy that takes into consideration all these factors in the rough and tumble of dynamic markets. However, to the best of our knowledge, nowhere in the literature does anyone inform us how to create such a system in the context of inconclusive and conflicting market information, debilitating emotions, and technical indicators that defy the static rules of the well-chosen example.

In other words, we are left with the two most important questions: How do you create a real-time profitable trading strategy that conforms to the unique psychological and methodological needs of the trader, and how do you accomplish this during the trader's natural lifetime, given the recent explosion of trading information; not to mention the usual false starts, detours, wrong turns, and omnipresent blind alleys.

Historically, books on trading concentrate either on teaching specific trading methodologies (i.e., Gann, Elliott Wave, Wycoff, etc.) without taking into consideration the idiosyncrasies of the trader or the real-time profitability of the method's application, or they focus on the importance of the psychology of trading without linking psychological insights to specific trading analyses, styles, and techniques (i.e., technical, fundamental, spreads, options, etc.)

The Outer Game of Trading focuses on several distinct trading strategies and demonstrates how each can be customized by the individual trader to be profitable, consistent, and personal. In addition, through revealing interviews with top traders Pat Arbor, Tony Saliba, Jeffrey Silverman, and Donald Sliter, we see how each methodology can be tailored to the unique requirements of any trader, much as the top traders customized their methodology to suit their own unique personalities.

The Outer Game of Trading concludes with a discussion of how to enhance one's personal performance on an ongoing basis in the choice, development, and application of a specific market strategy. Through real-life examples and interviews with market experts, we reinforce the importance of the concept that it is only after one has mastered the essential psychological skills of trading that one can fully take advantage of any trading system.

The Outer Game of Trading builds logically on the insights of its predecessor, *The Innergame of Trading* and offers, we believe, a valuable resource to traders that can measurably improve one's trading performance. Henry David Thoreau said, "Things do not change; we change." This is as true in trading as it is in every aspect of our lives.

Onward to successful trading!

Robert Koppel
Howard Abell

Acknowledgments

It is with a deep sense of appreciation that we acknowledge the many contributions of the traders and experts, friends all, who agreed to be interviewed in *The Outer Game of Trading*. Despite demanding schedules, they were generous with time and ideas, furnishing invaluable insight with respect to their trading strategies and market psychologies. In particular, we wish to acknowledge the input of Mark Douglas. The success of this book is a testament to the outstanding talents and fertile minds of its contributors. We are humbly grateful.

We also wish to thank our families, Mara, Lily, and Niko; Roslyn and Alex, for employing consistent strategies of patience, good humor, and respect for our work when it meant we had to spend many hours away from those we love.

We must also mention thanks for Mara Koppel's fine editing and to the entire staff at Probus Publishing for their support throughout this project. Specifically, we wish to acknowledge Kevin Thornton, Kevin Commins, and Sarah Sleight for their dedication to a shared standard of excellence.

Lastly, we would like to thank the many readers of *The Innergame of Trading* who have written and called, offering a wealth of ideas and suggestions. Their interest and enthusiasm has made all our work worthwhile.

Introduction

by Patrick H. Arbor
Chairman, Chicago Board of Trade

Success in the pits can be a very elusive goal. Successful trading requires discipline, guts and a certain degree of luck. Above all a successful trader cannot be afraid to fail. Most people who have attained some measure of success could write volumes about failure and, believe me, I am no exception.

When I first came to the Chicago Board of Trade, I lasted four years before I was forced to sell my membership. After twelve months of riveting I-beams on nascent skyscrapers I returned to the CBOT. That was 24 years ago, and I've been there ever since.

The difference between my failure and my success is that, the second time, I took what is all too often the road not taken. The pitfalls along this road are many, but the rewards can be great if a potential trader is disciplined and, critically, is not afraid to take a chance and risk failure. Every year at the CBOT I see one third of our trading floor population turn over. Usually, it is pretty much the same story: A lack of discipline, and an unwillingness to assume the risks necessary to turn potential failure into palpable reward.

If you take the risk, there is a chance that you will fail. An examination of history shows us repeated examples of noted achievers who suffered failure at some point along their own road. Thomas Edison was thrown out of school, thought to be unteachable; Michael Jordan was cut from his high school basketball team; even Abraham Lincoln lost a number of elections before going on the become one of our greatest presidents. However, each of these people came back stronger for their failure, rising from defeat like the phoenix, rising stronger and more beautiful from the ashes of his ruin.

In every setback, there is a lesson to be learned. If we are not intimidated by those setbacks, and instead absorb those lessons, we can educate ourselves, become more prepared to reach for success, and mroe equipped to attain it.

Of course, lessons can be learned in many ways. Perhaps one of the greatest ways to learn is by being around good teachers. If you want to be a good politician, for example, hang around good politicians. If you want to be a good writer, hang around with great writers. If you want to be a good trader, then hang around with good traders and trade with the best.

That's what I did. And here, perhaps, is where that certain degree of good luck comes into play. I was very fortunate to fall in with people who were not only good traders, but great people; people such as Henry Shatkin who helped me in such a way that I will never be able to repay him for what he did for me. For not only did I learn from him (and others) the outer game of trading, I benefited from their friendship, their wisdom and their good counsel.

These people showed me the human element that is so essential to any measurement of true success. Without question, that human element is a major component of trading, especially as practiced in the pits of the exchanges around the world. That is why the stories and methods of successful traders are so interesting and instructive, as you will find as you read *The Outer Game of Trading.*

"It's what you learn after you know it all that counts."
John Wooden

PART I
THE OUTER GAME

Chapter One

Strategy and the Overall Game Plan

A blind man walks into Macy's Herald Square, the largest department store in the world at the busiest time of day. Shoppers are moving in and out, back and forth, all around him. Suddenly, the man reaches down and grabs his seeing eye dog, a 120-pound black labrador and begins hurling the creature wildly above his head. The store's manager taking sight of this strange event hurriedly approaches the customer.

"May I help you?" he asks with restrained panic.

"No, thanks," answers the blind man matter-of-factly. "I'm just browsing!"

It occurs to us that, as traders, many times it feels as though we are wildly slinging a large, heavy dog blindly above our heads. This "big dog," if you will, may relate to a trading system or strategy or technique that we are trying to employ in the market but somehow is not producing the result that we desire. It feels as though it is being propelled by a centrifugal force all its own, with its own "unnatural" laws of physics. And at other times it seems as though we are mere browsers: We observe markets going up or down or trading within a range, and all we can do is "browse" rather than adopt a disciplined strategy in order to take effective action.

There are also some other times in the market when we feel way beyond the threshold of mere limited vision. We feel literally out of control; almost as if that big dog were swinging us around its head with a world of buzzing and booming sensations hopelessly speeding before us while we are spinning at breakneck speed in a chaotic frenzy that seems to make no sense; a random world of broken trading rules and ill-defined money management.

It has been our observation, based on 40 years of combined experience as exchange members (clearing and trading), traders, and consultants that there are two seemingly distinct dimensions of trading, each with its own characteristics and rules: the inner game and the outer game. It is only through a clear and precise understanding of each that ultimately allows us to take action, placing us irretrievably on the road to becoming successful traders. It is also important to know that the inner and outer games of trading are not mutually exclusive categories. They are part of a dynamic dualism, interdependent and mutually interactive.

It is said that the Hapsburg monarchs developed a very special wine that was the envy of all the world. It was called Essencia, the essence of the tokai grape. In fact it is reported that to produce this wine they pruned all but the strongest vines, allowing for the growth of only one grape per stem. The idea was to develop a wine that would give the pure essence of the tokai grape. Legend has it that these grapes grew literally to the size of grapefruits and offered a flavor so rare and wonderful that, in the words of one wine connoisseur, "It was like drinking the liquid life force of the tokai grape."

It is our intention in *The Outer Game of Trading* to describe in detail, those strategies in trading, both internal and external, that assure excellent results. It was Antoine de Saint-Exupéry who said, "That which is essential is invisible to the eye," a thought that was echoed by Leo Melamed when he attempted to identify the essence of a successful trader. He said, "The type of person you are—the way you react under pressure, your ability to make quick decisions, to think logically, the strength of your character, the emotional quotient of your personality, your philosophical approach toward money—will determine your probable chances of success or failure in trading. In futures trading, more so than perhaps in any other field of endeavor, your psychological makeup is critical. Alas, such characteristics are generally hidden from view." (*Leo Melamed on the Market,* NY: Wiley, 1993)

It is our goal to identify that essence and bring those characteristics not only into view but to describe specific patterns of thought and behavior (strategies) that produce outstanding results in the shortest period of time. (See Figure 1-1.) We base our findings on our trading experiences and research and on our interviews with the top traders. Figure 1-2 summarizes the interdependence of the inner and outer games of trading.

The Inner and Outer Game of Trading

The Innergame of Trading focuses on those issues in trading that influence the way we internalize market phenomena; that is to say, the way we personally represent the market (i.e., profits, losses, price action, timing, etc.) to ourselves. It was Karl Meninger who observed that what distinguishes people in life is not the events of their lives but the manner in which they react to the events in their lives. We believe there is an additional distinction that also needs to be made; what truly distinguishes people is not the way they react to life's events but the manner in which they interpret the events in their lives, which enables them to take positive and decisive action. *The Innergame of Trading* applies this insight to the way traders interpret issues relating to motivation, belief, self-esteem, and state of mind to their trading of markets.

Figure 1-1 The Inner and Outer Game of Trading

Inner Game	Outer Game
Motivation	Strategy (over-all planning)
Beliefs	Organization
Focus	Marshalling resources
State of mind	Defining outcomes
Attitudes	Developing trading rules
Thoughts	Applying well-defined risk
Goals	Management

Figure 1-2 The Interdependence of the Inner and Outer Games of Trading

INNER GAME		OUTER GAME		OUTCOMES
Motivation Beliefs State of Mind	→	Strategy (i.e., trading rules, control, etc.)	→	Trading Results (i.e., profit or loss)

The Outer Game of Trading focuses on the overall and specific actions that we adopt in the market as traders that are most effective both in terms of actual outcomes (i.e., profits) and in terms of identifying the processes (strategies) that are most successful in order to allow us to react to market phenomena in a way that is congruent with our personalities and ultimately yields the results we desire.

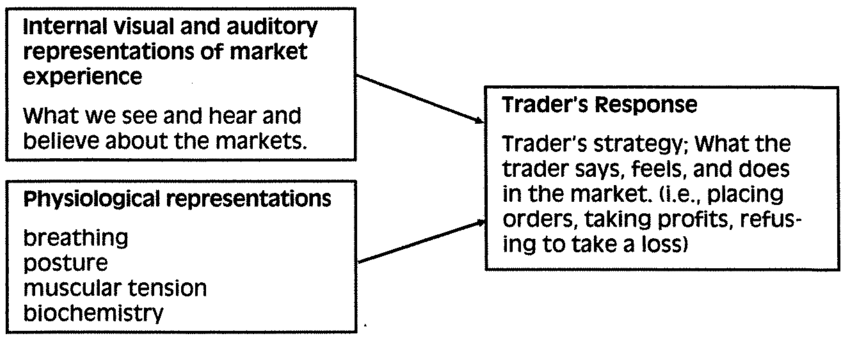
Figure 1-3 demonstrates the inner and outer games of trading in action.

> "Beliefs are the compass that guide us to know that we'll get there. . . . A strategy is a recognition that the best talents and ambitions also need to find the right avenue. You can open a door by breaking it down, or you can find the key that opens it intact."
>
> *Anthony Robbins*

According to Mark Douglas, the author of *The Disciplined Trader* (NY: NYIF, 1990), there are many paradoxes in trading. One of these paradoxes is the fact that you must approach markets with strategies that are based on probabilities; however, to be successful at trading you must consistently act from a psychological mind-set that is based on certainty. One can never know unequivocally where a market will go next but the paradox is that unless you act as though you do know you will never achieve an excellent result.

Dickson G. Watts, one of the most successful cotton operators of his day wrote, "Those who make for themselves an infallible plan delude themselves and others. Our effort will be to set forth the great underlying principle, the application of which must depend on circumstances, the times and the man." Watts listed

Figure 1-3 The Inner and Outer Games of Trading in Action



five qualities that he believed are the essential characteristics of the successful trader.

Self-reliance—Independence of thought, conviction, and action.
"A man cannot have another man's ideas any more than he can have another man's soul or body. Self-trust is the foundation of successful effort."

Judgment—To have an objective, honest view of the market.
"That equipoise, that nice adjustment of the faculties one to the other which is called good judgment is an essential to the speculator."

Courage—Confidence based on competence. To be decisive, automatic, resourceful. To trade in a state of mind that assures success.
"Confidence to act on the decisions of the mind. In Mirabeau's dictum: 'be bold, still be bold, always be bold.'"

Prudence—To have the ability to accurately define risk, to calculate and plan to develop strategies that consistently work.
"There should be a balance between prudence and courage. Prudence in contemplation, courage in execution."

Pliability—To be flexible, resilient, open-minded. The ability to change an opinion, the power of revision.

"He who observes," says Emerson, "and observes again is always formidable."

Perhaps you are wondering at this point: Isn't *The Outer Game of Trading* supposed to be a book on trading strategy? After all, you may be saying to yourself that you paid good money for this book. The least the authors can do is provide another discussion on the efficient market theory, fundamental and technical analysis, building a forecasting model (you're better off owning a crystal ball), spectral analysis, oscillators, traditional volume and open-interest methods, time cycles, wave theory, bull and bear strategies for puts and calls; not to mention structural theories, seasonal price movements, Gann lines, candlestick theory, and probability-of-ruin formulas.

> "One of these days in your travels a guy is going to come up to you and show you a nice brand-new deck of cards on which the seal is not yet broken, and this guy is going to offer to bet you that he can make the jack of spades jump out of the deck and squirt cider in your ear. But, son, do not bet this man, for as sure as you stand there, you are going to wind up with an earful of cider."
>
> *Damon Runyon*

Patience.

When we begin trading seminars we always start by asking the participants the following question: What are the personal characteristics of successful traders? As you think about this question, we think you will agree that some of the personal characteristics of successful traders are listed below.

disciplined	self-reliant
confident	motivated
personally responsible	competent
goal-oriented	self-aware
honest	optimistic
organized	objective
self-contained	knowledgeable
enjoys trading	determined
risk-managers	open-minded

focused	plans (strategic)
patient	committed
independent	automatic (effortless)
active	energetic
ambitious	manages stress
risk-takers	high-achieving
hard working	intuitive
______________	______________
______________	______________

We have left space for additional characteristics that you may wish to include.

Once we have generated this list and talked about each personal characteristic as it specifically relates to trading, we usually ask a follow-up question. Is there any one trader who possesses all of these personal characteristics? We have on occasion heard the names George Soros, Ed Seykota, and Jeff Silverman offered in response to our question, but in general, most people think there is no one person who possesses all of these qualities.

What do you think? Is there any trader who possesses all of the above named characteristics and, if so, who is he? We would like to suggest to you that you need look no further than the nearest mirror. Are you not convinced? Don't we all have these personal characteristics, granted in different degrees and in different proportions? The point is we all possess the ability, not necessarily the capability, to develop any and all of these personal characteristics in order to become more effective at trading and anything else. As Dorothy Parker put it, "We are all works in progress."

This is an important point to recognize because all trading success, we believe, evolves from the realization that it is through the development of personal characteristics (i.e., discipline, confidence, patience) that one creates the capability to devise strategies and techniques that will allow for a positive trading result. In fact, it is our belief that all trading strategies at the most basic level are an attempt by the individual trader to develop an external method to allow for the realization of these personal charac-

teristics. When in our research we asked some of the world's top traders to identify what allowed them to become successful at trading, it was almost always after a prolonged period of frustration, loss and disappointment—Tony Saliba contemplated suicide; Pat Arbor quit the Board of Trade for a year; Leo Melamed went broke three times—invariably the answer was not a specific method or technical approach. Tony Saliba's response was typical: "I learned how to focus, to become disciplined, objective." Pat Arbor said, "I just put my nose to the grindstone and got more focused, confident, consistent, and hard-working." Jeffrey Silverman said, "I was always a long-term trader but I had to learn how to give up 'the death wish of overtrading,' to become truly disciplined, to focus more on the long-term signal and less on the noise. By so doing I taught myself how to trade the market: to buy it when it had value and to sell it when it did not."

The list and the discussion that follow encompass what we believe to be the essential elements of a successful trading strategy.

- Assumes personal responsibility for all market actions.
- Takes into consideration your motivation for trading.
- Allows you to trade to win.
- Establishes goals and formulates a plan to take action.
- Controls anxiety.
- Creates a point of focus.
- Is consistent and congruent with your personality.
- Allows you to have an edge.
- Automatic—effortless—decisive in its implementation.
- Manages risk and assumes losses.
- Allows for patience and trading in a resourceful state of mind.
- Profit-oriented—practical as opposed to theoretical.
- Leaves no uncertainty.
- Allows you to produce consistent results.
- Identifies opportunities.

1. *Assumes Personal Responsibility for All Market Actions.*
   It isn't your broker, your brother-in-law, the chairman of the board of the Fed, the fill, the computer, the unemployment report—it is you!!! It's a simple fact that must be

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1. *Assumes Personal Responsibility for All Market Actions.*
   It isn't your broker, your brother-in-law, the chairman of the board of the Fed, the fill, the computer, the unemployment report—it is you!!! It's a simple fact that must be

understood in the adoption of any trading strategy: You produce the results. Good or bad, the buck stops here! The Nordstrom Corporation Policy Manual has just one sentence in it. "Use your own best judgment at all times."

2. *Takes into Consideration Your Motivation for Trading.*
Your trading strategy must reflect your motive for trading. If you like the excitement of being in the market perhaps you should consider not investing in software that takes four trades a year! It is important that your market behavior be consistent with your motive and motivation for trading.

> "A person usually has two reasons for doing something: a good reason and the real reason."
>
> *J.P. Morgan*

3. *Allows You to Trade to Win.*
Most traders don't trade to win, they trade not to lose. An effective strategy adopts a pro-active market behavior that allows you to play full out; to buy aggressively at your numbers; to catch breakouts; to enter and exit at your signals. And yes, to win you have to risk loss.

4. *Establishes Goals and Formulates a Plan to Take Action.*
Your strategy must have long- and short-range goals built into it. What are you trying to accomplish today? This week? This month? This year? In addition, what specific plan can you adopt (right now) to achieve this goal in terms of outcome, performance and motivation? Yes, there is a lot to think about!

> "The greatest mistake you can make in life is to be continually fearing you will make one."
>
> *Anonymous*

5. *Controls Anxiety.*
There are a variety of anxieties that we have to deal with at all times when we are trading. A well-planned strategy minimizes anxiety by addressing the factors that inevitably produce those feelings (i.e., loss, risk-control, market re-entry).

6. *Creates a Point of Focus.*
   The problem with most trading strategies is that in the final analysis there is no point of focus. You must know what you're looking for and what you're looking at. You must be able to distinguish the signal from the noise, winning from losing trades, high-probability from low-probability outcomes.

7. *Is Consistent and Congruent with Your Personality.*
   How many times have we been consulted by traders who have told us their strategy (system) just doesn't "feel right," "look right," or "sound right"? Too many! If your strategy is going to be successful, it literally must feel good.

8. *Allows You to Have an Edge.*
   Unfortunately there is no "edge" sold at the local department store, ready-made one size fits all. It is just one more paradox of trading that in order to trade successfully you need an edge, but someone else's edge will do you no good. One man's sugar is another man's salt also applies to edge. You have to find your own and this fact is essential to having a winning strategy!

> **"If you bet on a horse, that's gambling; if you bet you can pull three spades, that's entertainment. If you bet cotton will go up three cents, that's business. See the difference?"**
> ***William F. Sherrod***

9. *Automatic—Effortless—Decisive in Its Implementation.*
   "He who hesitates is lost."

10. *Manages Risk and Assumes Losses.*
    A good trading strategy has the inevitability of loss built into it, so when you lose it is assumed to be inevitable and not unusual. Risk management assumes that no single loss will ever get out of hand. As in baseball, hitting safely three out of 10 times can pay off very handsomely. Your strategy must inform you with certainty when you're wrong.

11. *Allows for Patience and Trading in a Resourceful State of Mind.* Once the trade is made, your strategy must allow you to remain calm, patient, and focused by presenting you with criteria of an objective (they're really all subjective) nature. You must work out, in your own mind, the contingency plans for dealing with a variety of market scenarios. Anything less is gambling!

> **"The person involved responsibly, both intellectually and behaviorally, with the experience of trading may, to paraphrase Theodore Roosevelt, know at his best the triumph of high achievement, but if he fails, he will have failed while doing greatly and so his place will never be with those timid souls who know neither victory nor defeat. Perhaps, then, in the final analysis, it may be as rewarding to travel as it is to arrive."**
>
> *Teweles and Jones*
> The Futures Game
> *(NY: McGraw-Hill, 1974)*

12. *Profit-Oriented—Practical as Opposed to Theoretical.* This point may seem obvious, although in reality it's not. There are many traders who develop strategies to be consistent with a particular ideological or technical bias rather than to make money. The name of the game is performance! Winston Churchill said, "It is a socialist idea that making profits is a vice; I consider the real vice is making losses." This is a point to be remembered in trading as well.

13. *Leaves No Uncertainty.* Think in probabilities, trade in certainties. Your strategy must allow you to know!

14. *Allows You to Produce Consistent Results.* Your strategy provides the organization and order to allow you to be consistent. The rest is up to you!

15. *Identifies Opportunities.* According to Anthony Robbins, "The difference between those who succeed and those who fail isn't what they have—it's what they choose to see and do with their resources and

their experiences of life." This also applies to trading. Your trading strategy should allow you to open your eyes and see market opportunities . . . so that you can act!

Chapter Two

Strategies That Work

Strategy: Process of determining your major trading goals and then adopting a course of action whereby you allocate the resources necessary to achieve those ends.

Tactics: A process of translating broad strategic goals into specific objectives that are relevant to a single component of your trading plan.

In order for a trading strategy to be successful, it must incorporate all the psychological, technical, and financial resources that are at your disposal. In metaphorical terms your strategy is the bull's eye; specific trading tactics are the arrows that allow you to hit the target of your over-all trading goals. The difficulty with most trading strategies (unsuccessful strategies) is that they don't adequately deal with the central issue of trading: namely, taking a loss.

> **"All men can see those tactics whereby I conquer, but what none can see is the strategy out of which victory is evolved."**
>
> *Sun-Tsu, Chinese Military Strategist (4th century B.C.)*

In *The Psychology of Technical Analysis* (Chicago: Probus Publishing, 1994), Tony Plummer states this issue very succinctly. "The question for the trader is whether it really is possible to divorce the longer-term goal of profitable trading from the potentially traumatic short-term effects of incurring losses. The answer lies in the making of two specific commitments. The first is the commitment to use a technical trading system which provides automatic entry and exit criteria and which incorporates money management principles. This encourages the trader to remain disengaged from the emotional contagion of the market place and to limit his risk. The second commitment is the adoption of an attitude toward oneself which is supportive of trading. The basic need is to maintain the energy levels necessary to cope with the inevitable shocks and vicissitudes of the markets."

> **"Make no little plans; they have no magic to stir men's blood and probably will not be realized. Make big plans; aim high in hope and work, remembering that a noble, logical diagram once recorded will not die."**
>
> ***Daniel Burnham***

Psychological Considerations

In our experience most traders deal with the issue of loss in a variety of maladaptive ways, the most common of which are the following:

- Denial
- Inaction
- Confusion
- Anger

> **"Nothing ruins my day like losses!"**
>
> ***Gordon Gekko,***
> ***in the movie* Wall Street**

Denial

Is it any wonder most traders are not getting the results they want in the market? We think not! The reason we have come to this conclusion is that most traders choose to trade with their eyes closed, ears shut, and nervous system turned off. How else could you tolerate a trade that continues going against you, day after day, with no defined risk, until the discomfort has gotten so severe that even the Novocaine you've self-administered can no longer stave off the pain? Denial won't help. Snap out of it!

Inaction

There is an old American saying that goes like this: "If you sleep on the floor you can't fall out of bed." Many traders have adopted this "position" when it comes to the question of risk. If you don't pull the trigger, they think, you can't miss the target. But the truth of the matter is you have to pick up the gun and steady your aim—that is, know what you're shooting at—before you can pull the trigger with confidence. Developing a strategy with a specific point of focus (i.e., Elliott Wave, Fibonacci, Gann, etc.) and possessing the intellectual recognition that taking a loss (the real fear) is not only inevitable but essential will give you the conviction (belief) to exploit market opportunities and not miss out.

It is only when missing out becomes more psychologically painful than being inactive that triggers get pulled and targets get hit.

Confusion

Confusion and uncertainty result from not working out a well-defined risk management formula prior to opening the specific trade that you're in. You will recognize that reevaluating the cost of your summer vacation at the time your gold position is sinking to new lows is not an optimum trading strategy. The more emotion that can be eliminated from your trading, the greater your sense of clarity about market decisions. Jeffrey Silverman made this point very well when he said, "Doing things that avoid having an emotional content in your decision-making is where all the discipline comes in . . . Be unemotional about getting in, be unemotional about the position, and be unemotional when getting out."

Anger

Reacting to the market out of anger is like choosing to hold your breath until your neighbor turns blue. It's not going to work! Your anger will not affect the loss positively. It certainly may influence it negatively by turning a small loss into a large loss!

Taking a Loss

There is another aspect of taking a loss that is rarely addressed in books on trading and that is the physiological and emotional responses that inhibit the development and implementation of an effective trading strategy. Learning to take a loss is the single hardest lesson a trader has to learn. This is no intellectual lesson; taking a loss involves every aspect of the human being. The following nine figures describe how traders respond to taking a loss.

Figure 2-1 Physical Symptoms of Taking a Loss

- Rapid or shallow breathing
- Sweating
- Constriction of muscles
- Upset stomach
- Tension
- Feeling of malaise

Figure 2-2 Emotional Symptoms of Taking a Loss

- Angry
- Depressed
- Disillusioned
- Distracted
- Generalized anxiety
- Irritable
- Frustrated
- Low self-worth
- Embarrassed

Figure 2-3 Visual Imagery Traders Process Internally When Taking a Loss

- Sights of past failures
- Pictures of trading obstacles and disappointments
- Visions of unrelated mishaps of a generalized nature

Figure 2-4 Auditory Imagery Traders Process Internally When Taking a Loss

- The voice of doom and failure
- Replaying negative experiences from the past
- Remembering why you are such a "jerk"

Figure 2-5 Kinesthetic (Sensory) Imagery Traders Experience When Taking a Loss

- Body feels heavy
- Shoulders droop
- Torso is hunched
- Facial muscles slacken
- Breathing is short and shallow
- Eyes are cast down
- Trader feels slow, weak, or out of energy

Figure 2-6 Anxiety Traders Experience Relating to Loss

- Fear of failure—Trader feels intense pressure to perform and ties self-worth to trading
- Fear of success—Trader loses control; euphoric trading; trader doubts himself
- Fear of inadequacy—Trader experiences loss of self-esteem, diminished confidence
- Loss of control—Trader loses sense of personal responsibility when trading; feels market is out to get him

Figure 2-7 Thoughts Traders Have When Taking a Loss

- "I don't know what I'm doing."
- "These markets are impossible."
- "I'm too small, inexperienced, young, old, etc."
- "I don't have a clear strategy."
- "What will X think of me?"
- "I'm a loser, fool, idiot etc."

Figure 2-8 Beliefs Traders Possess About Themselves and the Market When Taking a Loss

About the Market

- "The market is rigged."
- "It's impossible to have a winning trade."
- "The locals always pick me off."
- "You can never get a decent fill."

About Themselves

- "I can never make a winning trade."
- "I'm such a _____ I can never make a good trade."
- "I have to be perfect."
- "If I take a loss, then I'm a loser."
- "If the market doesn't do exactly what I expect, I don't know anything."

Figure 2-9 Self-Defeating Attitudes Traders Possess When Taking a Loss

- Holding yourself to impossible standards
- Trying to please others
- Thinking in absolute terms
  –black or white
  –all or nothing
  –total success or failure
- Focusing on negative things
- Believing your childhood or past experiences have programmed you for failure
- Demanding certainty of yourself and the market
- Defining trading as impossible
- Representing a bad trade as a catastrophe
- Labeling yourself in a globally negative way rather than just looking at "the trade"

Psychological Strategies That Assure Success

In describing the psychology of a successful trader, Leo Melamed said, "Living as a pit trader day after day teaches you many things about the people who inhabit this arena. You learn to distinguish the good traders from the bad, the successful techniques from the unsuccessful, and the good habits from the faulty. You also learn to distinguish the lover from the fighter, the winner from the losers, the serious from the frivolous, the cerebral from the superficial, and the friend from the foe. But above all, you learn that the psychological makeup of the trader is the single most critical element of success." Figure 2-10 summarizes the syntax of successful trading.

The psychological skills of winning

There are a number of psychological skills that we have identified as being critical for success in trading. They are:

- compelling motivation
- goal setting
- confidence
- focus
- state management
- positive imagery
- mental conditioning

Figure 2-10 The Syntax of Successful Trading

Well-analyzed trade
↓
System of empowering personal beliefs and attitudes
↓
Proper execution based on positive focus
↓
Decisive, resourceful state of mind
↓
Successful trading performance

Compelling Motivation. Compelling motivation is possessing the intensity to do whatever it takes to win at trading; to overcome a bad day or setback in order to achieve your trading goals. Think of the intensity of a world-class athlete: fully engaged and not afraid to play the game; not afraid of "being there," totally involved in the moment.

Goal Setting. Goal setting is imperative to the trader, not only in terms of setting realistic and measurable goals within the context of a specific time frame, but also in terms of enhancing motivation and performance. Setting goals, in fact, conditions the trader on an on-going basis to boost his trading to the next level. It is excellence not perfection that is the point here—excellence produces results; perfection produces ulcers.

> "When I'm trading well, everything seems effortless and automatic."
> *Donald Sliter*

Confidence. Confidence based on competence is purely a result of motivation, belief (in oneself and the market), and state of mind. Confidence in psychological terms is no more than consistently expecting a positive outcome. Think of anything you have ever done in your life with that feeling of confidence (positive expectation). Did not that feeling ultimately predict a successful result? It is the same with trading. Successful trading could be illustrated graphically by Figure 2-11.

Focus. The tighter your focus, and the finer the distinctions that you bring to your trading focus, the better the results. Focus is one of those terms that sounds like a cliché unless you understand how to utilize it in your trading. It is through focus that one stays consistent and is able to maintain a high level of confidence. Focus derives from developing a specific strategy that allows you to feel certain and act accordingly.

> "Think in probabilities, act in certainties."
> *Bob Koppel*

State Management. How you feel at any given moment in time will determine your state of mind, including what you feel physi-

Figure 2-11

Well-analyzed and strategized trade (based on probabilities) →	Automatic execution (based on confidence) →	Successful trading result (whether the trade makes or loses money)

cally, represent visually and process emotionally about your trading. Learning how to manage your state will determine whether you hesitate or act and whether you are emotionally drained or physically and psychologically energized. Figure 2-12 summarizes successful trading performance in terms of what we see, hear, and feel.

Positive Imagery. We have the power and ability to choose what imagery we process in our minds and bodies. We can literally choose the character and intensity of the images (feeling on a physical level) that are of a visual, auditory, and kinesthetic (physical) nature. We can see failure or success, trading loss or market information, paralyzing circumstances or trading opportunities. It is your mind—you run it! Figures 2-15 through 2-19 describe the kind of imagery that enhances one's trading performance.

Figure 2-12 Successful Trading Performance

Bodily Response	Visualization	Auditory
Body feels light. Shoulders are erect; torso is straight. Facial muscles taut, breathing deep and relaxed. Eyes looking up and stratight ahead. Trader is feeling strong, energized and enthusiastic.	Seeing yourself succeed. Watching yourself in control, relaxed. Looking competent, confident, and positive.	The voice of confidence and control. The sound of relaxed, effortless trading.

Figure 2-13 The Winning State of Mind

Resourceful State of Mind ⟶ **Strategy** ⟶ **Positive Trading Response**

- Anxiety free
- Self-trusting
- Confident
- High self-esteem

Figure 2-14 Psychological Characteristics of the Winning State of Mind

- Expect the best of yourself
- Establish a personal standard of excellence
- Create an internal atmosphere for success based on compelling motivation and focus
- Communicate effectively with yourself; see yourself as positive, resourceful, self-empowering

Figure 2-15 Visual Imagery That Enhances Performance

- Picturing success
- Seeing yourself in control
- Looking competent, relaxed, confident, positive
- Viewing a positive visual image that improves your performance

Figure 2-16 Auditory Imagery That Enhances Performance

- Hearing the voice of confidence
- Saying to yourself "I knew I was right"
- Listening to the voice of positive expectation

Figure 2-17 Kinesthetic Imagery That Enhances Trading Performance

- Body feels light, confident
- Body is energized—strong
- Focus is direct and alert
- Breathing is relaxed, effortless, long and deep

Figure 2-18 Internal Process for Enhancing State

Visual	Auditory	Kinesthetic
brightness	loudness	even
color	duration	warm
contrast	pitch	cold
distance	tone	pulsating
location	location	intermittent
shapes	direction	strong
size	rhythm	relaxed

Figure 2-19 Positive Beliefs That Enhance State

- I believe I am or will be a successful trader
- I believe I can achieve excellent results in my trading
- I believe I can identify and execute winning trades
- I believe I can trade with confidence
- I believe I can trade effortlessly and automatically
- I believe each day's performance is fresh
- I believe I am personally responsible for all my trading results
- I believe I can be successful without being perfect
- I believe my performance as a trader does not reflect on my self-worth
- I believe one bad trade is just that
- I believe trading is a process
- I believe that by believing in myself and in any proven methodology and by approaching trading each day with a fresh, positive state of mind, I possess the ultimate trading edge

Mental Conditioning. The psychological skills necessary to trade successfully require ongoing conditioning. They must be practiced day in and day out. They are at least as important as your daily chart work!

The Essential Psychological Barriers to Successful Trading

In *The Innergame of Trading* we described in detail the essential psychological barriers to successful trading, based on our trading experiences and interviews with some of the world's top traders.

We repeat the list here, but refer you to *The Innergame of Trading* for further discussion.

- Not defining a loss
- Not taking a loss or a profit
- Getting locked into a belief
- Getting "Boston-Strangled" (taking a tip)
- Kamikaze trading
- Euphoric trading
- Hesitating at your numbers
- Not catching a breakout
- Not focusing on opportunities
- Being more invested in being right than in making money
- Not consistently applying your trading system
- Not having a well-defined money management program
- Not being in the right state of mind

"Vital people have faith and they have hope. They feel they can manage their destiny and go about it enthusiastically. They exercise their minds as well as their bodies. When anxiety creeps in, it is short-lived. What is meaningful and important is a personal decision and a sign of inner direction. Whether by instinct or deliberate design, potent people choose their life directions and get on with the process of enthusiastic living. They have succeeded in facing down their inner saboteurs and purging themselves of the negatives in their belief systems."

Joe Alexander,
Dare to Change
(NY: Signet, 1994)

The Recipe for Trading Success

In *The Innergame of Trading* we discussed the recipe of the top traders that allows for consistent positive results. We offer it again below. But first let's take a look at the inner game of most traders.

Figure 2-20 The Inner Game of Most Traders

- Identify market signal (i.e., point, line, etc.)
- React in a confused, anxious or inconsistent manner
- Trader feels "bad" (angry, guilty, nervous, hesitant, etc) about the trade

Figure 2-21 The Inner Game of Top Traders

- Identify market signal
- React automatically with confidence and self-trust
- Trader feels "good" (confident, high self-esteem, etc.) about the trade

* * *

Technical Considerations

> "When I lose money by reason of some development which nobody could foresee, I think no more vindictively of it then I do of an inconveniently timed storm."
>
> *Edwin Lefevre*
> *in* Confessions of a Stock Operator

The specific technical system or approach that is utilized must allow for the realization of these three conditions by providing the following:

- Market position and/or trend identification
  –Is the market in an uptrend, downtrend or trading range?
- Automatic entry and exit
  –Where do I get in?
  –Where do I get out?
- Defined money management
  –How much do I invest when the market doesn't share my enthusiasm for my position or appreciate my point of view? (Even though I know I'm right!)

Once these three factors—market position and/or trend identification, automatic entry and exit, and defined money management—have been adequately addressed, it should become obvious that a 360-degree universe exists for the trader to exploit market opportunities.

We are now going to look at some basic market strategies.

The Basic Strategies

In essence there are only a few "basic" strategies for trading markets, although they are used interchangeably by participants in an endless number of exotic combinations. They are:

- Scalping
- Day trading
- Position trading (with varying time horizons)
- Spreading
- Options trading

Scalping. On the floor of the exchanges, scalpers are the equivalent of market-makers in the securities world, although unlike securities traders they are under no obligation to make markets. Their main focus, plain and simple, is to make small profits by carefully calculated surgical attacks in order to capture small price changes on each transaction. The scalper limits his exposure by moving quickly with a closely defined risk, which, given his short-term perspective, also limits his profit potential. Whether conducted on or off the floor, this method of trading is based primarily on volume rather than on a large profit potential on any given trade.

Day trading. The day trader's focus is more long term than the scalper's. He seeks to identify pivotal points in the market's daily action. He searches for entry points based on perceived buying and selling climaxes, retracements, trend-line pull-backs, and the like. His risks are also close and well defined but with increased upside potential because he is looking for critical daily turns that may materialize into larger market moves. Typically the position is liquidated at the end of the trading session. This strategy does not allow for the exposure of an open position overnight.

Position Trading. The position trader's time horizon may extend anywhere from a week to years. His trading is based on a well-formulated calculation based on price level or market economics that may be arrived at by either a fundamental or technical bias or a combination of the two.

Hedgers and commercials are predominantly position traders. Position traders will stay with their opinion until market dynamics have aligned measurably, targeted price levels have been reached or fundamental economic conditions have changed. There is of necessity greater risk in position trading although it is still well calculated. Profit potential is also greatly increased given the expansion of risk and perspective.

Spreading. Spreaders can be scalpers, day traders, or position traders. The techniques that they utilize, however, are fundamentally different from those of outright traders. The spreader focuses on the differential, that is, the difference in price between one futures contract month and another contract month, or the difference in prices between related markets (i.e., corn and wheat, gold and silver, Eurodollars and bonds). Although successful spreading strategies always involve good risk management, the unlimited spreading possibilities create widely varying risk/reward ratios. Leo Melamed said this about the successful spreader in the futures market.

> "The professional spreader is an artist. His aptitude, agility, and ability to detect the slightest market shift is extraordinary. He is constantly active, moving as a buyer of one month to a seller of another, and immediately back again. In fact, many spreaders perform this activity among three or four contract months at the same time. The object is to pick up even the smallest increment of profit in the shift of the differential(s). The spreader is always alert to a new offer or bid on one given month that could be spread profitably into another month. He is quick to react to any sudden down-draft or up-draft in the market so that he can unwind one side of his spread for that small moment of market movement

"A most important aspect of planning is to have a plan. Another is to follow it. A plan not followed is like an automobile seat belt not buckled. A plan should be kept to oneself. When other people are looking over the trader's shoulder, things start to go wrong, because she begins to attach some importance to their reactions to what she does when they really should not affect what she does at all. There is always some apparent reason for trying for still more profit or not taking a loss. If the trader lacks the discipline to set objectives and risk limits and to act when either is reached, he should not trade futures. The trailing stop seems to be an infallible device for taking advantage of big moves with modest risk. This device rarely works.

"Plans may be difficult to devise and adapt to one's own trading preferences, and even a carefully conceived plan may not work. Markets may act in a way in which they have never acted before, and all the work that went into a plan's preparation may appear to have been wasted.

"Discouragement from time to time is part of the game, and famines have a way of following feasts. Despite any apparent disadvantages, there can be no doubt that trading with a game plan is far better than trading without one."

Teweles and Jones
The Futures Game *(NY: McGraw-Hill, 1974)*

and hook it up again as soon as the price movement has stopped." (*Melamed On the Markets*, NY: Wiley, 1993)

In *The Futures Game* (NY: McGraw Hill, 1974), Teweles and Jones defined the strategy of spreading.

"The word 'spread' has several meanings to commodity traders, but all imply a price difference. Spread in its most general sense applies to the difference between the cash and futures prices of the same commodity. In its more restrictive senses it may refer to the differences in the prices between various contract months on the same futures exchange or the differences in prices between the same or different months in the same or related future on exchanges located in different cities. A spread also describes the actual position taken by a trader who is simultaneously long one commodity contract and short another. The trader may hold equal but opposite positions (legs) in two or more different contracts of the same commodity . . . Historically the terms 'spread' and 'straddle' have had shades of difference, but they have since become interchangeable among commodity traders and in practice the word 'spread' is now more commonly used in the futures markets."

Spread position strategies are always based on the concept of differential. Each strategy is based on the trader's bias to market direction, seasonality, volatility, and individual performance within or outside of particular market groups. Figure 2-22 displays different kinds of spread positions.

Reasons for Adopting a Spread Strategy

1. To capture the price differential between intracommodity, intercommodity, or intermarket spreads.

Figure 2-22 Most Common Types of Spread Positions

Strategy	Example Trade	Rationale
Intracommodity Spreads	long March corn short May corn	May is a discount to March and traders anticipate near-term bullishness
Intercommodity Spreads	long gold, short silver	given the historicals and chart pattern, traders believe this market bias fundamentally justifies the trade
Intermarket Spreads	long CBOT wheat short KCBOT	traders believe differential is out of line

2. To capture the price differential based on market bias.
3. To capture the price differential based on time and volatility.

Note that differential is the operative word here. If you are not spreading for differential, don't do it!

Reasons for Not Adopting a Spread Strategy

1. Because it's easier than taking an outright position.
2. Because taking a net long and net short position always defines your risk more clearly.
3. Because in spreading you can't lose a lot and it's easier to get out.
4. To spread off a loss (prevent an open loss from becoming a realized one).
5. To reduce margin requirements.
6. To spread a market because there's nothing outright to do.

Spreading can be costly when not considered in terms of the internal logic of the differential. Spreading can in fact be many times more costly than outright positions. Anyone who has ever been the "wrong way" on old and new crop spreads or currency spreads understands this point very well!

Strategy Selection

Specific strategy selection is based on considerations of price, timing, volatility, and direction. In addition, the trader must also consider risk/reward characteristics of the trade, expected returns, and percent of equity to invest.

Options offer a very attractive avenue of investment because they present so many strategic possibilities. In addition, strike prices and expiration can be selected to create a myriad of interesting market opportunities.

Options Trading

What follows here is a list of options trading strategies based on various market scenarios. For example, if a trader expects stable prices in the near term, he could sell straddles, sell strangles, etc.

Stable Prices
Sell straddles
Sell strangles
Ratio write
Short butterfly
Ratio spreads

Bearish Strategies
Buy puts
Bear spreads
Sell calls
Sell instrument—buy call
Covered put write
Buy put—sell call

Volatile Prices
Buy straddle
Buy butterfly

> "Would you tell me please, which way I ought to go from here?"
> "That depends a good deal on where you want to get to."
> *Lewis Carroll,* Alice in Wonderland

Fundamental Analysis

Fundamental analysis is concerned with supply and demand factors, which influence the price movement of futures contracts. Fundamental analysis is concerned with market trend over a relatively long period of time. Traders rarely use fundamental analysis exclusive of technical considerations.

Figure 2-23 Time Decay Tactics

Time Helps	Time Hurts	Time Mixed
Short call	Long call	Bull spread
Short put	Long put	Bear spread
Short straddle	Long straddle	Long butterfly
Covered call write		Short butterfly
Covered put write		

Factors Entering into Fundamental Analysis

1. Supply and demand factors
2. Degree to which each subset of supply and demand factors are important (i.e., production, imports and exports, and usage)
3. Seasonal and cyclical considerations
4. Monetary and fiscal policies
5. Government reports
6. Political developments
7. The relationship of market prices to volume, open interest, and hedging interest

The main problem with a fundamental approach is answering these two questions:

1. Where do I get in?
2. How do I know when I'm wrong?

Another problem with fundamental analysis is that the significance of information within the context of price action is hard to evaluate; it is the rare trader who can distinguish the signal from the noise. As with all other strategies in trading, fundamental analysis is subject to individual interpretation, like deriving meaning from the old axiom buy low and sell high. There are, however, successful traders who employ fundamental analysis consistently. Jeffery Silverman and George Segal stand out in this respect.

> "I look at what I think the risk is in a position. I look at what I think the return is likely to be. I try to maximize what's in my account in terms of the most bang for the buck. In terms of return for risk. In terms of return for margin dollar investment. Then, as I've gotten more successful, I tend to just keep dialing down the amount of risk per margin dollar so that I can trade with an even longer term perspective."
>
> *Jeffrey Silverman*

Figure 2-24 Profit/Loss Characteristics of Option Strategies

Strategy	Profit	Loss
Buy Call	Unlimited	Limited
Buy Put	Unlimited	Limited
Short Call	Limited	Unlimited
Short Put	Limited	Unlimited
Covered Call Write	Limited	Unlimited
Covered Put Write	Limited	Unlimited
Bull Spread	Limited	Unlimited
Bear Spread	Limited	Unlimited
Long Butterfly	Limited	Unlimited
Short Butterfly	Limited	Unlimited
Calendar Spread	Unlimited	Unlimited

Classical Chart Analysis

One of our fundamental assumptions is that no trading system is perfect although the use of one is essential for trading success. For a trading system to be successful, it must be profitable, consistent, and personal. Let's begin by looking at some of the basic concepts of classical chart analysis. Our goal is not to identify familiar chart patterns or recognize potential market signals but rather to demonstrate how a fully integrated trading strategy can be developed around these basic concepts, resulting in a system that is profitable, personal, and consistent over time. Our focus here is not to teach technical analysis but rather to demonstrate its conception and execution within the trader's overall strategy, which is his inner and outer game of trading at work.

> "He who travels the fastest travels alone."
>
> *Rudyard Kipling*

We begin with the belief that, contrary to the view of most academics (nontraders), markets do not trade randomly. Any trader who has spent time studying simple price charts can easily verify the upward or downward bias of most markets. This bias within a defined time frame is referred to as a trend. Trends can be seen, as stated in *The Innergame of Trading,* as market psychology at work.

Trends—Catching the Big Wave. The classic definition of a trend, "higher highs and higher lows," has a strong psychological foundation. Emotionally and intellectually, there is great comfort for the trading public when a market makes new highs, falls off, and fails to make new lows in a particular period of time. Traders then become willing buyers at higher price levels and sellers are only attracted to the market at even higher levels. Of course, the opposite is true for downward trending markets.

Whether the markets are trending up or down, or, for that matter, not at all, there is an opportunity for profit. The top traders have all devised some methodology or combination of methods and techniques to trade markets with consistency. It doesn't matter if the trader is a fundamentalist or a technician, each one has developed a unique solution to markets. This solution we call a trading system. It's important to understand that trading systems are nothing more than an attempt to put order into a chaotic world. The world of trading markets.

The trading system gives the trader the ability to control his or her emotional states rather than allowing them to control him or her. A system is a disciplined method for organizing dynamic, ever-changing market phenomena.

As we stated earlier, a successful trading system is composed of a number of independent elements that are joined together to make the whole. These elements are discrete but mutually interactive. They are:

- Trend identification
- Entry and/or exit signals
- Money management capability

Before we move on to a detailed discussion of trading systems and classical chart analysis, we must caution the reader again that our focus is not on an in-depth study of the technical aspects of trading markets, but rather on how our emotional states and the psychological skills we have learned relate to the development and execution of a successful trading strategy. As we have clearly seen, it is the inner game of the trader that determines if the system or the specific analytical methods of choice will be successful.

The primary methods of trend identification are:

1. Linear—trendlines
2. Moving averages
3. Channel breakouts

- *Trendlines:* Trendlines (see Figure 2-25) are the simplest device to use to indicate a trend. By drawing a line from low to low to establish an uptrend or from high to high to establish a downtrend we can easily and quickly define a market's trend.
- *Moving Averages:* Moving averages (see Figure 2-26) are usually obtained by adding up a series of closes and dividing the sum by the number of days used in the series; they are effective in smoothing erratic market movement and indicating trend. Usually a trend is said to be in effect when the market is trading above the moving average (uptrend) or below the moving average (downtrend).
- *Channel Breakout:* The channel breakout (see Figure 2-27) is created when a market trades within a confined area of highs and lows within some specified time and then moves out of this area, thereby establishing a new trend. The channel can also be said to be a sideways trend; many traders find this type of market very profitable.

Strategy Criteria. There is a difference, of course, between learning to identify market trends and implementing a successful trading strategy that profits from that knowledge. Many traders can easily define the trends on a chart but few are successful in profiting from this information. How many times have you heard a trader say, "The market came right down to my trendline, or

Figure 2-25 Trendlines

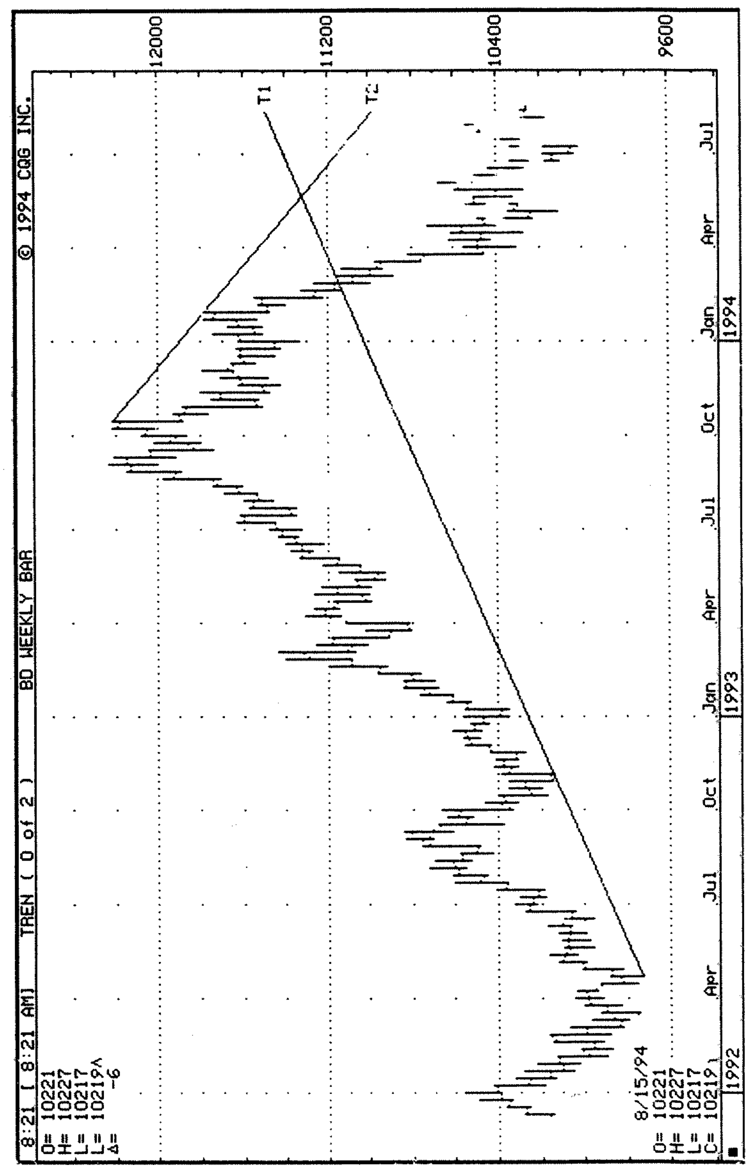

Figure 2-26 Moving Averages

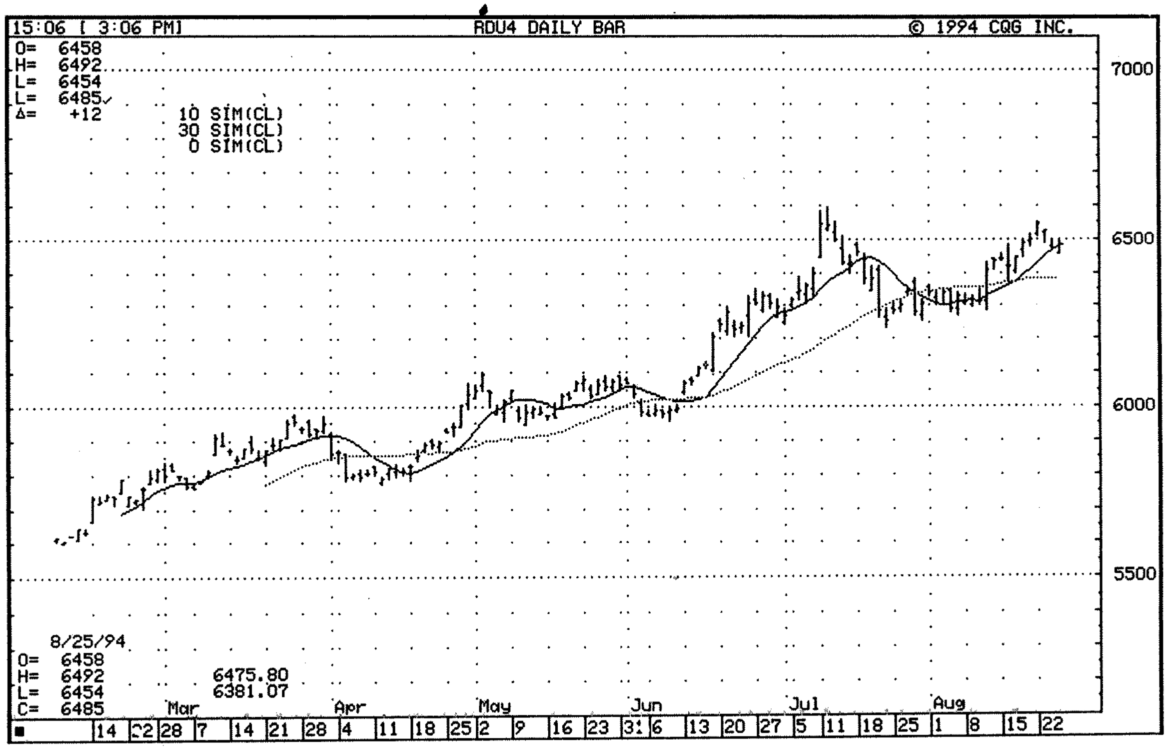

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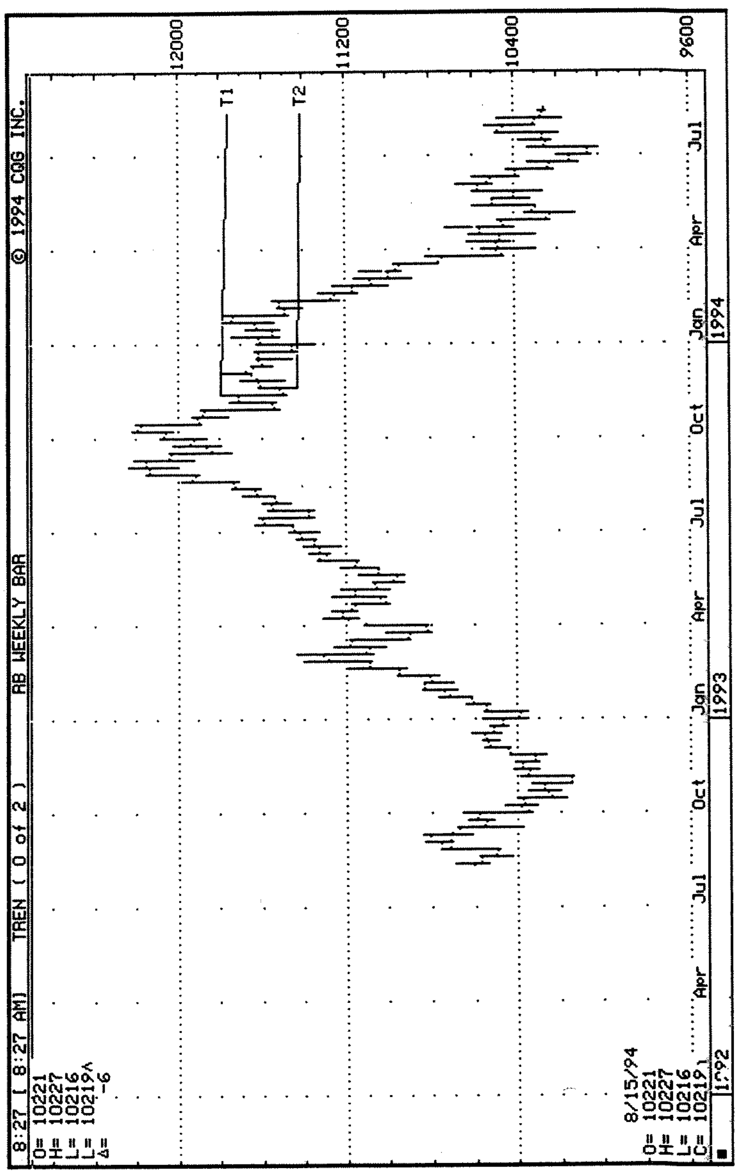
Figure 2-27 Channel Breakout



moving average, or old low, and I couldn't pull the trigger"? Have you heard that from anybody you know? Maybe someone you know personally? A trading strategy that you create and feel in control of can overcome the many psychological and emotional barriers that prevent a trader from taking advantage of well-defined and recognized market opportunity.

Choosing a Strategy. One simple strategy that can be used effectively is to buy the market any time it falls to an uptrend line or sell the market any time it rallies to a downtrend line. If the market violates the line by some number of our choosing then we automatically exit the trade. So, you ask what happens if the market stops us out and then goes back over or under the line? Easy! Let's make a reentry signal part of our strategy and go back into the market.

What we have created above is a simple strategy that will enable the trader to do what we have found all the top traders do. That is, they identify a signal or reason to enter the market. They act automatically and, because they are in control, they feel good about the trade whether it turns out right or not. They know if they get stopped out, they can always get right back in. As Bruce Johnson said, "The trick isn't falling off the horse or even riding away carefree into the sunset. It's simply knowing once you're knocked off all you have to do is get back into the saddle. It's not easy; that's why there are so few great traders."

Reversal Patterns. More often than not, markets do not end an established trend easily or quickly. Bottoms (see Figure 2-28) are usually quieter and take a long time to develop except for the occasional spike or double bottom that occurs in a short period of time. Tops (see Figure 2-29) are quicker to form, are often very volatile and are accompanied by lots of noise and attention. These patterns include:

- Head and shoulders bottoms
- Head and shoulders tops
- Double bottoms and tops
- Rounded bottoms and tops
- V or spike bottoms and tops

Figure 2-28 Bottoms

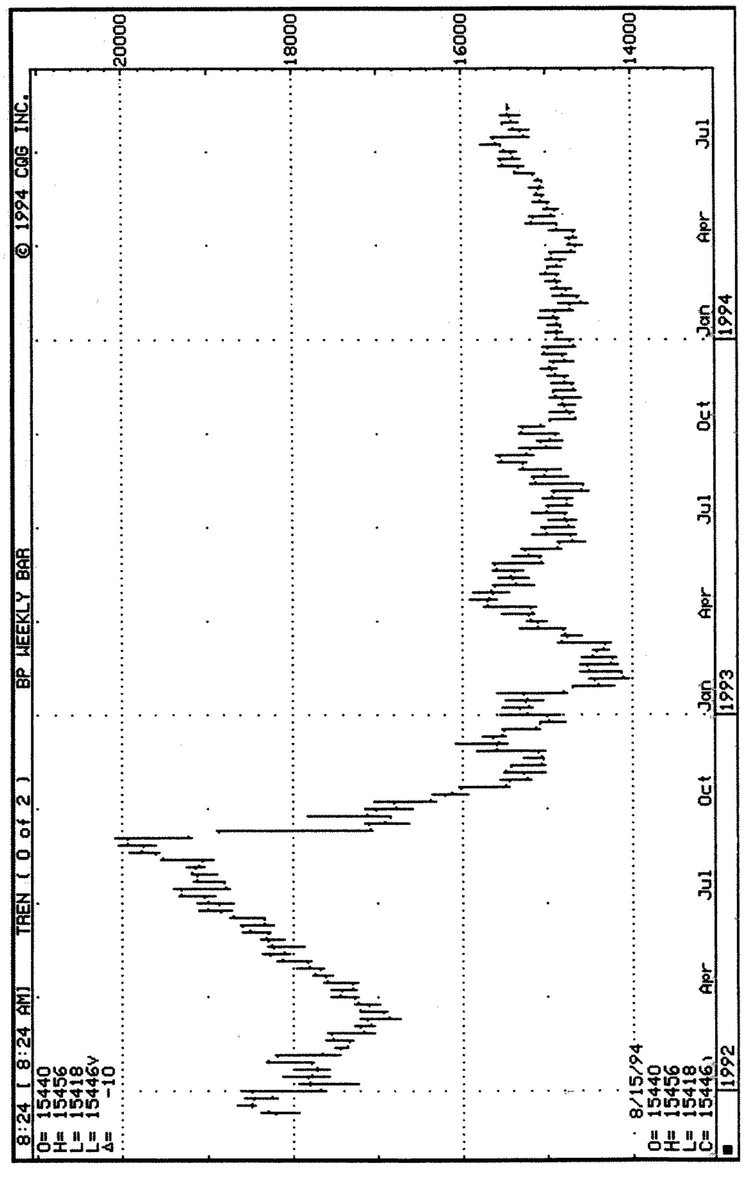


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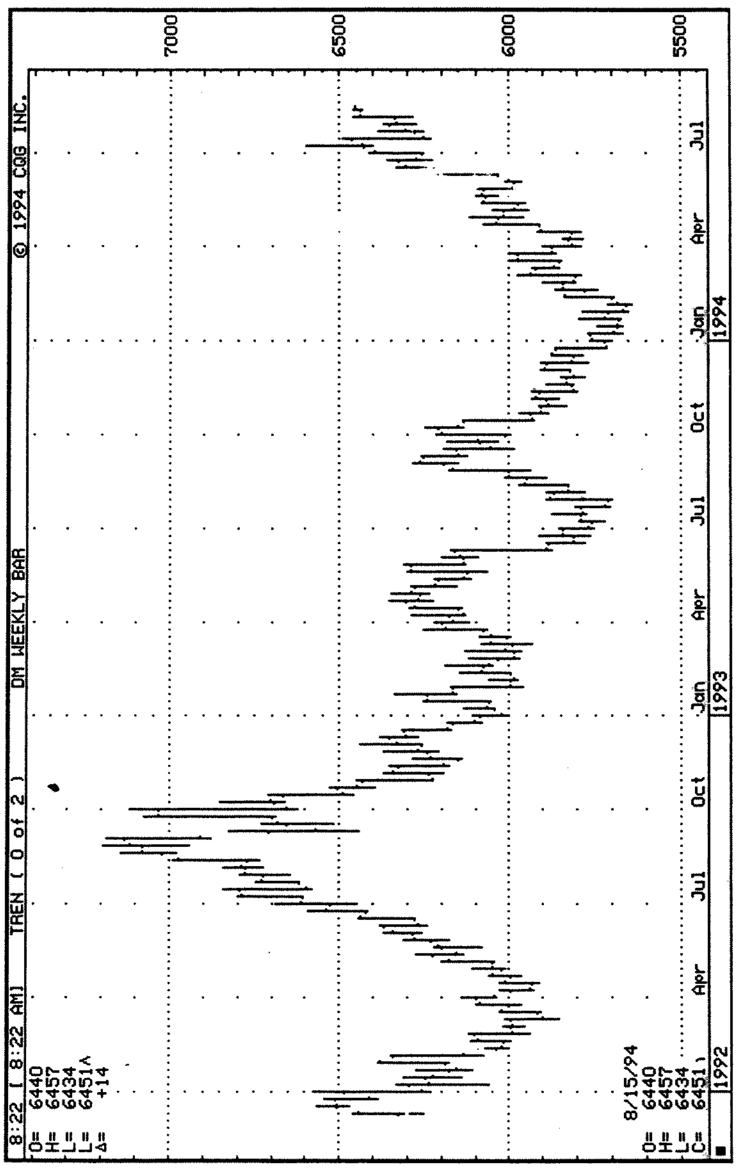
Figure 2-29 Tops



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Many traders see these reversal patterns develop and watch them turn into very strong trends without ever entering the market. Indecision, doubt, fear, lack of confidence, and confusion make for missed opportunity. Creating a strategy that automatically gets you into the market, defines your risk and takes you out at the proper time is key to capturing profits from these easy-to-read patterns.

Many of these reversal patterns have high probabilities of success. Acting on these signals when they occur therefore should translate into a high probability for profits.

A strategy designed to enter the market each time a bottom or top appears to be completed can be highly successful. It's the strategy that instills the confidence and strong belief which will make the trader consistently take these trades.

Continuation Patterns. After a trend has been established and the market has moved away from its basic trendline, a series of patterns called continuation patterns are formed. (See Figure 2-30.) They are pauses in the established trend and offer excellent opportunities to enter the market with limited risk in the direction of the main trend.

Here again is an opportunity for a trader to design personal strategies to take advantage of reliable patterns set up by the market. As a market moves significantly in one direction it will very often pause over a short period of time. It could be several days or a week or two. The patterns created by the market during this period offer opportunities to profit from the price movement within those patterns or to enter the market in the direction of the trend at reduced risk. Flags and triangles (see Figure 2-31) are examples of common continuation patterns. The trader can devise several strategies that fit his personal trading style in order to take advantage of these patterns.

If you are more comfortable buying breaking markets, then a strategy that waits for a market to re-test or even break the low end of a continuation pattern offers a low risk area to make that trade. Defining the risk and knowing that you are buying in an area that offers a high probability of success will allow you to have the

Figure 2-30 Continuation Patterns

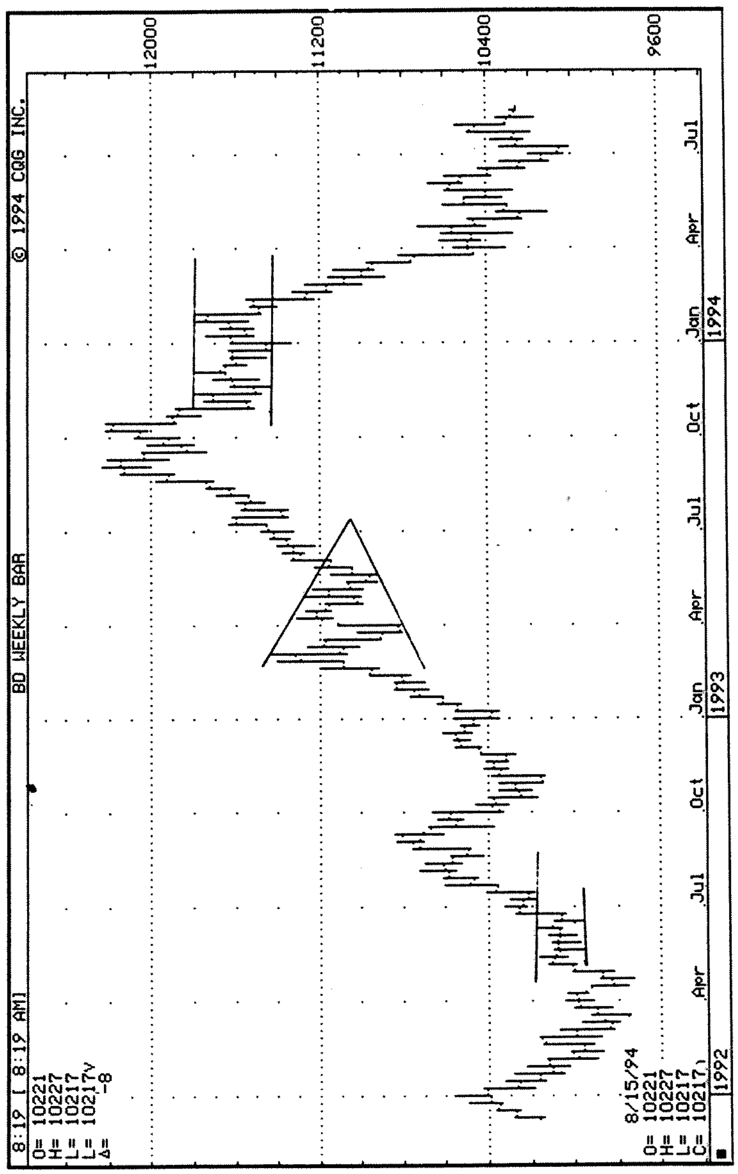
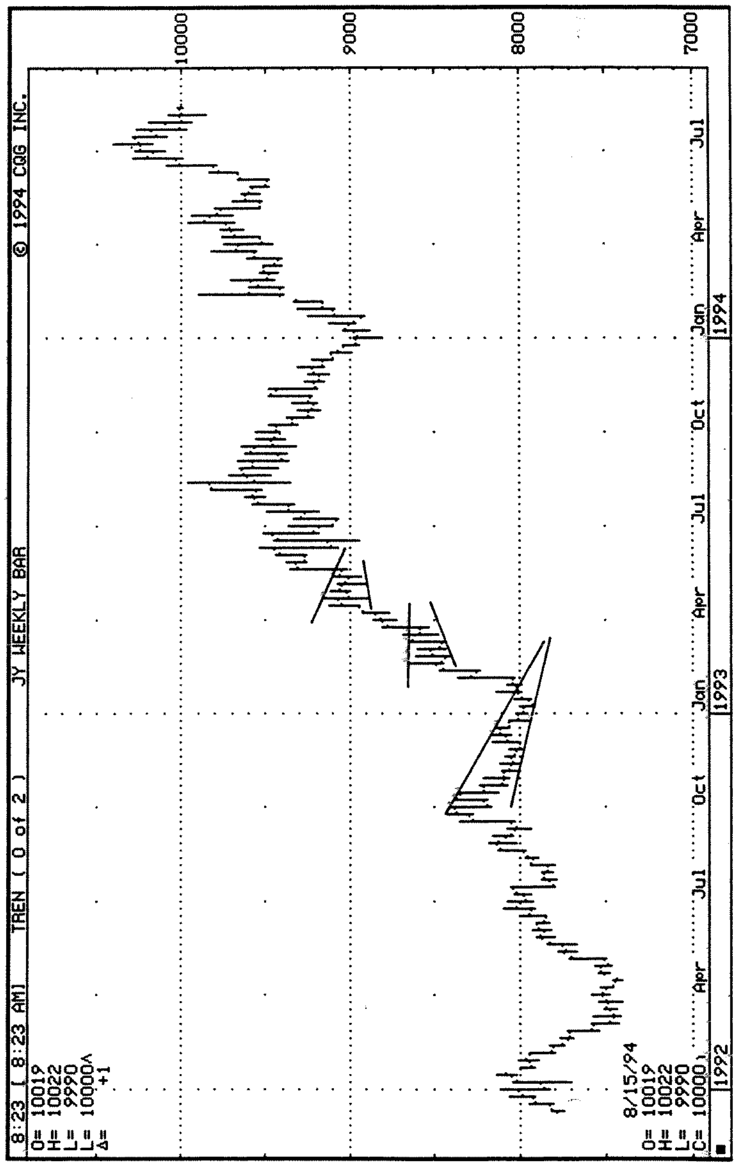


Figure 2-31 Flags and Triangles



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confidence to make this trade. If your objectives are to play for the top end of the pattern, you will already have a profit area in mind. If your goal is to enter a trending market, then you have accomplished that and can wait for the market to resume its trend.

Some traders are more comfortable buying or selling the breakout of these patterns. That is, they wait for the market to show that it is resuming the trend and then buy or sell into that trend. This strategy can be very successful when the market is in a strong trend as the probabilities are high that a breakout of a continuation pattern will be successful. Risk can be defined with this strategy in several ways and many traders feel most confident when a market moves out of these patterns. The point to remember is that one's personal market strategy and psychological skills of enhanced belief and confidence are what enable personal involvement in the market at these times.

Money Management. This discussion on creating strategies for the various technical patterns would not be complete if we did not include the most important element of all—money management. No strategy will be successful over time without proper money and risk management. Traders accept that they cannot be successful 100 percent of the time if they make a series of trades. The top traders know that they will be successful 40-50 percent of the time and include the concept of small losses and larger profits to net them significant results. If there is one common thread among the most successful traders it is the discipline of taking small losses in order to manage one's trading equity.

In conclusion, we have seen that a variety of approaches based on an overall sound trading strategy will work; however, the key point is that a strategy—unlike a collection of tactics—is fully integrated; that is, it assumes the decisive implementation of psychological as well as mechanical skills. It allows you to trade to win by creating a well-defined point of focus which controls your anxiety and at the same time allows you to execute trades with certainty, effortlessly and automatically.

The Strategy's Effectiveness. After you've selected your strategy, ask yourself the following questions:

- Does the system generate profits and feel good?
- Does it leave you certain?
- Is it consistent with your overall goals?

System Design. As you evaluate and reevaluate your system, what factors are most important to you? Do you take into consideration any of the following, and how much weight do you personally place on each factor?

- Trend lines
- Moving averages
- Channel breakouts
- Other indicators
- Entry and exit
- Reentry
- Time
- Profit targets

Chapter Three

Setting Goals and Defining Your Big Picture

Setting Goals

> "The greater thing in this world is not so much where we started as in what direction we are going."
>
> *Oliver Wendell Holmes*

The positive effects of goal setting are universally known. Goal setting is valuable because it establishes the overall aim or purpose of your trading actions. In addition to identifying what you are specifically attempting to achieve, setting goals also increases motivation and measurably raises performance levels. Setting goals has the following positive characteristics:

- Identifies what is important to you
- Increases motivation
- Directs your focus
- Identifies relevant trading strategies

1. **Identifies what is important to you.**
   Trading goals help put things into perspective. They provide direction and point you toward your intended outcome by the quickest route.

2. **Increases motivation.**
   You can reach your full potential as a trader only if your motivation and effort are high. Setting goals provides for a continuing energized attitude. Keeping your goal in the forefront of your mind motivates you to work harder, give more effort (physically and emotionally) and keeps you striving to improve.

3. **Directs your focus.**
   Goals direct your attitude to accomplish specifically those patterns of thought and behavior that allow you to become disciplined, confident and consistent.

4. **Identifies relevant trading strategies.**
   Your goal allows you to identify the overall strategy and those specific techniques which will allow you to accomplish your trading objectives.

Figure 3-1 The Importance of Trading Goals

Goal	Benefit	Trading Behavior
Performance goal	Focus on improvement in relation to your own standards.	Increases physical and psychological skills related to trading.
Outcome goal	Helps determine what's important to you.	Allows for the development of techniques and strategies which match your personality.
Motivation goal	Helps increase effort and direct attention.	Allows traders to maintain a high level of enthusiasm and confidence.

Figure 3-2 Operational Definition of Trading Goals

- **Specific**—clear, precise, well-defined.
- **Time-framed**—state within a specific time period.
- **Positive**—stated it in a way that is empowering.
- **Control**—trading goal should be completely within your control.
- **Realistic**—making a million on your first trade does not satisfy our definition.
- **Measurable**—easily quantifiable.

Figure 3-3 Monthly Goal Chart

My long-term goal is ____

My goal for this month is ____

My goal for this week is ____

My strategy for achieving these goals is ____________________________

____

____

Figure 3-4 Factors that Prevent Traders from Achieving Trading Goals

- Self-limiting beliefs
- Unresourceful state
- Poor focus
- Ill-defined personal strategy
- Lack of physical and psychological energy

Self-Limiting Beliefs

Inhibiting beliefs about oneself and the market. Examples of such beliefs are:

- "I'm uncertain."
- "I don't believe in myself."
- "How can I be sure?"
- "How do I know I won't get a terrible fill?
- "How can I compete with the locals?"

Unresourceful State

An unresourceful state is when the predominant emotions a trader is experiencing are anxiety, confusion, and fear. Traders report the following:

- "I'm angry."
- "All I feel is frustration."
- "I'm just afraid to pull the trigger."
- "I just close my eyes and pray."
- "I want revenge."

Poor Focus

Poor focus results from trading with distracted concentration, when the trader's point of focus is not crystal clear, laser straight. Traders report:

- "All I can think of is the last loss."
- "Those bad fills keep getting in my way."
- "Why do I always get head-faked?"
- "I can't see the forest for the trees."
- "I'm always distracted just at the point of decision."

Ill-Defined Personal Strategy

An ill-defined personal strategy is characterized by trades that are made with a high level of emotional content. Trading becomes little more than an impulse response to one's personal state. Traders who have experienced this report:

- "I'm trading by the seat of my pants."
- "I don't have a clear plan."
- "My methodology is no more than a collection of tactics."
- "Sometimes it works and sometimes it doesn't."

Lack of Physical and Psychological Energy

Lack of physical and psychological energy results from high anxiety levels. One experiences tension and resulting physical and psychological fatigue. Traders have told us:

- "I just feel totally wiped."
- "I'm a psychological zombie."
- "I don't have enough energy to trade."

Goal Setting Guidelines

Learning to set realistic but challenging goals is not a mystical process. What follow here are specific steps to take to reach your trading goals.

1. Identify Your Goals
   - What are your trading goals?
   - What do you want to accomplish?
   - What is your long-term goal?
   - What is your short-term goal?
   - Why is it important for you to achieve these goals?
   - What is preventing you from achieving your goal right now?
   - What specific actions or steps can you take to achieve your goals today?
   - What are your greatest weaknesses as a trader?
   - What do you find most interesting about trading?
   - What do you find most enjoyable about trading?
   - What do you find least enjoyable about trading?
   - How much effort, time and money are you willing to commit to trading?
   - Is it important for you to trade by feel?
   - Is it important for you to have a totally mechanical system?
   - What does the ideal trading system look like to you?
2. Set Challenging Goals.
   - Do you prepare mentally for trading?

- Are you physically prepared? (we're not joking)
- Do you understand the strategic aspects of trading effectively?
- Are your mechanical skills well-honed?

3. Set Specific Measurable Goals and Target Dates.
4. Set Performance Goals for Motivation, Outcome Goals to Identify the Big Picture.
5. Find Success in Everything You Do.

In *The Mental Game* (New York: Viking Penguin, 1990), James Loehr makes this point as it relates to tennis. We believe it applies equally well to trading: "If losing is equated with failure, the battle of confidence cannot be won. Your motto should always be, 'Win or lose, another step forward.' You can find success in a losing effort when you establish clear performance goals prior to the match. You have the potential to learn much more from a loss than a victory. When you set your goals properly, your confidence can continue to grow, independent of your match's outcome."

PART II
MODELING EXCELLENCE

Chapter Four

Strategies in Action

We asked well-known market experts how they utilize their trading strategies in the rough and tumble of dynamic markets; in other words, to walk us through not only their trading approaches but to invite us into their thought processes, the way they think about strategy, starting with the analysis of the trade, through its execution, to its closing out, whether it is a winning or losing position. We asked them to describe, in their own words, the essential characteristics of a successful trading strategy.

The Experts

John Slazas is president of J.S. Services, a consulting firm specializing in risk-management technology.

Robin Mesch is the chief fixed-income technical analyst for Thomson Research, one of the largest providers of proprietary financial information services in the world. She is a recognized expert on Drummond Geometry.

Douglas Sooley is president of Intra-Day Dynamics, a financial futures consulting firm serving institutional and private investors. He is also an independent trader.

George Segal is an independent trader. He is a long-term member of the Chicago Mercantile Exchange, IMM, and IOM and owner of the former FCM, CSA, Inc.

Marshall Stein is senior vice president of Rand Financial Services and a member of the board of directors, Chicago Mercantile Exchange. He is an independent trader and former member of the Chicago Board of Trade.

John Slazas

For me, the strategy is everything; that's how I approach the markets. I formulate my trading strategies prior to any trading session, before I go into battle, before I go into the ring.

I'm a technical trader so I focus on the technicals. I'm not a fundamental trader, but I do read and know the fundamentals. My trading is also relatively short term. My time parameters vary between a half-hour to two weeks. So when I am formulating a strategy, I am always using technical analysis, and the first thing I like to do is focus on the potential for the trade. What's my immediate potential? Is there extended potential? I say to myself, "Okay, here is an opportunity to make some money." Then I ask myself, "Will this strategy work for or against the current trend?" And I want to know the time frame of the trend I'm dealing with, long or short term. Now I, know precisely, in my mind, where am I wrong. I also ask myself where I no longer like this position and where the momentum shifts against me. Then, lastly, I focus on the risk. What do I have to risk here?

I form my strategy prior to the session. As I've said, I have my parameters all set up in my mind and now it's implementation time. I take the plunge. It's time to step over the line. I've done my studies. I've crunched my numbers. I've done my models. I've got all this information and then I kind of take a step back and let my body feel the trade and look at what kind of vision I see. One might say intuition!

Now at the heart of my system is risk management. I would like to talk a little bit more about strategy. I consider myself a risk manager. This is something that I've really tried to raise to an art form with J.S. Services. When I analyze the inherent risk of a trade, I look at the market as a series of levels and price bands. We've established our position. I've taken our stand, but say for instance I now want to sell the market. I put a risk management overlay on that position. So now the trading base starts. I have my position and the market is moving. If I'm wrong, my initial strategy is going to say okay, I am wrong, I'm out of the market. If I am right, I am always continually adjusting parameters.

In terms of analyzing trades, the main thing you come up with in your strategy is determining whether or not you like the market. I want to buy it or I don't want to buy it. I want to sell it or I don't want to sell it. Then you look for areas. Where can I enter this market? Maybe your ideal point is a 100 points higher, and remember, we approach the market on a low-risk, longer-term basis. We do most of our research the night before. That's how we approach the market. We are very patient and pick our points carefully but sometimes the market doesn't give us opportunities. That's why we focus on seven markets: five currencies, the bond market, and the S&P 500.

I want to say something about my strategy for taking profits and losses. I usually like to have the market take me out of the trade. I have my risk management overlay that I readjust with a trailing stop on a position, where I will have targets that I will want to see attained. But I usually like to see the market take my target out and kind of spike through my target and then I adjust my stops downward. When the market can't sustain that failure or that upside violation, then I am going to get taken out of my position. It's rare that I will come out and pick a bottom or a top to exit the position.

I think that separates my approach from that of most other traders. Most traders, as you know, are always talking about catching the top or buying the very bottom. They think that unless they are able to do that, the opportunities are limited. That's absolutely not true in my experience.

We do give some away, depending on the size of our position. If we are in a good trade and we've gotten in at a favorable area where we will be able to add to our position, we will be more aggressive with one part of our position than with another, so we will be able to take full advantage of that market. If we are missing 40 points on a 300 point move, you know that's fine!

As you know, everybody talks about discipline, patience, and focus. I think I owe a great deal of my success to my ability to operationalize these concepts.

We have a two-part approach. We have a research approach where we format our strategies and then we have an execution approach. Most of our clients are professional traders. They have the feel or intuition about the market. In most cases, they are looking only at the numbers and the text and who is buying and who is selling. They look to us to provide them with the research, the technical overlay, and the risk management system.

In our case, the discipline comes from being able to utilize the research on a consistent basis in the face of the emotion of the market. If you don't have the discipline to implement your strategy to make use of your research and execute, you won't be successful. As you know, success in trading is elusive for most traders and one of the reasons, I think, is that most traders try to forecast the market. They say this is where the market is going. They don't really see reality. And they put their reality on the market right or wrong or they fight it until the inevitable. They keep giving it a little more room until it's too late and they take a bigger loss than they had anticipated.

Another huge challenge for traders is being able to achieve consistency. If you want to succeed, you've got to be consistent. But how do you do it? Definitely by following the rules of your risk management system. That is your consistency. That is the only consistent thing you have. You can't predict what the markets are going to do. But you can follow your system. You can hold true to what your research and strategy have proven over time with a statistically significant sample. And as you know, this is so difficult for most people because even though they have a strategy all worked out they allow a momentary feeling or thought, an emotion, to dictate their rules.

A trader must have rules that he can and will follow. Stick to your rules! And if you can't do that, if you can't have that discipline, you shouldn't be in the business. I look at myself as a risk manager. I have an opinion on the market, I take a position and then I manage that risk, plain and simple. I also see myself as someone who can implement that strategy consistently over time and build on those strategies and constantly enhance those strategies. As I see different market conditions materialize, I implement appropriate risk management for those conditions. I'm constantly refocusing.

I want to make one other point. It is important to have a strategy that is consistent with your personality! It has to be something that comes from your heart, that you really believe in; you have to format it yourself and have it be true to who you are. If someone else's strategy is a winner for him, chances are pretty good it will be a dud for you.

Personally, I think sports offers the best insights into trading. In fact that's what really interested me about your first book, *The Innergame of Trading*. I used to play competitive racquetball and I could see how your concepts apply to sports. It is essential that you learn how to separate your ego from your body in order to achieve excellence. And I really feel that trading is the same way. When you can attain the unconscious state, where your ego is out of it and you're just executing, that's when you are really performing at higher levels.

So the question is how do I attain that state?

I practice a lot. You know that is what I do. I am always trying to practice the mental side of trading. I love to snowboard. It's a very demanding sport. It's very fast. You really don't have time to think. It can also be life threatening. You definitely prepare yourself for what you are going to do and be in the physical shape to do it. Once you take the plunge and you are going down the run, you have to let your mind go and be able to respond. Sounds a lot like trading!

You really have to understand yourself. Understand what makes you afraid and what makes you go, what gives you confidence in yourself that you can believe and trust yourself. Without that, you can't trade. You will not have the ability to execute a system or formulate winning trading strategies.

Robin Mesch

I was at Brown University and a friend asked me if I was interested in learning a trading system called Drummond Geometry, in order to teach it to an investor. The investor bought all the books and I learned the method, then taught it to him. In the process, I got hooked on technical analysis. Thirteen years later, I still love the analysis. I love figuring out what the next step of the market is going to be. I enjoy looking at the patterns, thinking about all the different possibilities that the market can present the next day. That's the analysis part, of course. Then there's planning my attack. I also like being right, because that's a real thrill when you pull the trigger and what you imagined was going to happen unfolds. I like the immediate gratification that trading affords you above all other disciplines.

Never underestimate the importance of having a well-developed trading strategy! Your trading strategy puts you in the moment, but you have to know what you're going to do prior to going into the day. Know where you're going to buy and sell: Not only know where you're going to enter the market, but know what has to happen in between your entry and your exit in order to keep you in the trade.

My own analysis is based on a lot of research. That's what I do when I'm not trading. I'm always working toward automating my thinking. The computer is an incredibly useful tool for clarifying your thoughts.

Although I'm always working towards the Holy Grail of having the ideal, automated signal generator, there is always an element of subjectivity in my trading. For the present, the computer does all the grunt work involved in calculating support and resistance, which would be about 80 percent of the work if I did it by hand. However, while the computer is doing the work, I still have to do the thinking. I'm trying to eliminate that, but I am not currently at that stage. I will always have to put in, every day, some element of the subjectivity that is too subtle to program. But there is never subjectivity when it is time to pull the trigger; all the subjectivity should have gone into the analysis the night before.

What the computer accomplishes very successfully is filtering out many of the misconceptions about particular patterns you might otherwise think work. In fact, they often don't work, in a statistically significant sense, once they've been tested. As you work with the computer more and more, it actually trains your brain to see patterns more objectively. My style and strategy are to take little bits of the market out of larger patterns that I've recognized and tested. I never go for the whole move, so I am assured of my exit price. I leave lots of money on the table, because I like playing ranges, and every day, week, and month is a new range that you can make money off of.

Let me take you through a particular trade so you get to see what my strategy looks like. As you know, I trade the 30-year bond and, for the most part, my strategy is concentrated on the day trade. That means my focus bar is the daily range, as opposed to someone who is concentrating on the weekly or monthly. But, even though I am a day trader, which again means I'm zeroing in on my daily range, the first thing I always do is check out the weekly and monthly chart. I look at the next two higher time periods to determine direction for that day.

The first thing I look at is where the daily is in terms of weekly and monthly support and resistance. I look at my monthly, and I say, "Did the month as a whole, accumulate or distribute?" I have frames of reference based on Drummond Geometry to tell me that.

If the daily is already in weekly and monthly support, then I'm going to expect an up bar for the week, and I am going to look to buy daily support. Or I may need to wait one to two days to make sure the daily is accumulating weekly support for a higher confidence trade. I've found from my testing that a one-time-frame trader doesn't really stand a chance, and that multiple time periods are key in assuring higher probability trades. If I'm looking to buy daily support after I've seen some signs of accumulation on, say, the hourly or 30-minute chart, then I want to buy the pattern where the market is putting its low in first. That means if

I have an objective for my day trade, then I don't want the market to be there first before I go in long. The probabilities really go down in that case.

Getting in is about a third of the battle. So say I'm in the trade and I'm long in daily support which has flagged weekly support after showing some signs of accumulation. That's just the entry. You have to monitor on a lower time period of hourly or 20 minutes or whatever. If the market begins to build value where you bought, it means accumulation is weak and you could be wrong. That would be a reason to exit. What we're looking for to happen on the lowest time period is a trend run-up, which should take you near your goal. Once the market gets near your goal, you're looking for distribution, and you have to be flexible. Distribution may happen a little bit ahead of your number. That's why you use lower time period resistance to hone and refine where exactly the market is telling you to exit.

So, for instance, last month in the bonds, the market distributed. And I look at the chart and say, "Now what did the bond market distribute off of and where are the high potential spots that will distribute the market again?" Then I take these monthly levels, of which there may be two or three, keeping in mind that I think the direction will be down, and I put them on my weekly chart. Let's take a look at this past week. As you know, the whole week has shown accumulation. On Monday, the bond market opened low, into support, and the low was put in first. That put me in a tricky situation in terms of my strategy! The market is in a down month, and so it's going to get up to its monthly high from my point of view by putting in a weekly low first, and it's going to move . . .

You see this was a problematic situation because it suggested countertrend! Remember that the daily had been in a downtrend. If the weekly low has been realized first, this implies to me that the daily has got to go into consolidation. And it may have to exit to the upside, and this is actually what my letter has been talking about for the past six days. We had a position on that was short, which was the situation entering the week. However, we entered on the lows for the week. Now the market could have either collapsed or, as I just mentioned, had a high probability that the low was already in place. So we had to get out, or think about reversing.

So there we are. You open at the low, maybe for the week, and you're thinking about buying. You know that to meet your criteria, the market is going to have to force the daily into congestion action up in order to keep trading it from a downtrend. Moving to an up type of trading would show accumulation at weekly support. So again, I go into my day, and I say, well, we are in a down type of trading market, looking for a reversal. . . . With Drummond Geometry, you are always certain. It works by using a variety of analytical tools to identify support and resistance. If this market is going to go from down to up, you use specific tools, specific calculations that say, this is support . . . to allow you to determine if it is going from down to up. So now we have identified the levels that we were looking to buy for the day. I've used two higher time periods, and I'm off my daily focus bar, and now I have to monitor that entry off an hourly and a 30-minute chart.

The key point is that before I enter the trade, I'll say, this is where I want to enter tomorrow. This is support, and I'm going to expect an up bar. Now the first thing I want is the set up. And that means the low has to be put in first, because if it's going to be an up day, about 85 percent of the time the market puts in its low bar first and then moves up! That's what we've gathered from our testing. According to our testing, the low gets put in first on an up day, both in bull and bear markets. We've actually gone back to around 1982 and 1983 to test this. So, first I want the set up, and I often say in the letter, do not take this trade if the target hits prior to entry, because that means it's a down day, and I could get that trade tomorrow, so why suffer the exposure?

So that's the set up and before I'll take the trade or recommend the trade, I have to do the math. This is where the money management comes in. I have a lot of clients who call me in pain. If you've done your math, there shouldn't be pain. If this is where I'm going to buy, what do I have to hide behind, and where do I expect that range to get to?

Now, in my mind I'll have a much larger range than where I'm willing to get out. I think that's okay, because I've become more discriminating on the front side about which trades I'm taking to begin with; besides, I think of my stops as just protective in case of disaster.

You see, I don't usually exit on my stops. I usually exit in the monitoring phase of the trade because often I can see what's unfolding. Once entry has been taken, my strategy is to determine what has to unfold; that will keep me in or get me out of the market. So, anyhow, I'll enter and I'll know what the pain's going to be for the trade, and I usually even just prepare to lose. Every time I take the trade, I decide prior to entry, what the ultimate pain of the trade is, so, in that way there are no surprises.

I have always found losing to be a total learning experience. I've read many books on really great traders, and I've noticed that, at some point in their career, they've all suffered huge losses. At some point in their life they've had a big drawdown that was almost devastating. I think these are key moments in a trader's development, and, for me, any big loss has caused me to have a major shift in my understanding about the market.

In our early days, my partner and I were in a platinum trade one time and, definitely, no question about it, were on the wrong side of the market. We knew it, but decided to hold on, because we thought it would come back. I've probably been through every single classic trading error that you read about in the books. It was so devastating. I think we didn't trade for a month after that. We felt the financial loss and the emotional experience that surrounded it—being so dumb and so attached to staying with that trade—so attached to winning that we couldn't cut our losses. The whole horrible experience became a great learning opportunity for me.

I just refused to admit that I was wrong! There'd be days where we'd actually have a sheet over the face of the computer! I was incredibly lucky, because I had a very positive partner. We bounced back. We might have been dumb, but we were incredibly optimistic. . . . We've always been optimistic!

As a result of that experience, the whole way I strategized a market improved. It really hammered home to me the importance of preparation. I spent five or six years analyzing 12 markets for at least four hours every day. I thoroughly knew each market inside and out and did a write-up on each one with my expectation for the day, week, and month.

I studied, studied, studied. And tested. At that time, I was lucky enough to work with a programmer, Cindy Brown, who is now my partner. The bulk of our day was spent programming, and then the bulk of my night was spent analyzing the market. So the point I'm trying to make is I got a renewed determination to figure out these markets. I was willing to do whatever it took to be successful.

I want to make another point. What you believe about yourself, and what you believe about the market, literally affects every aspect of your trading, not only in terms of your analysis, but in your entry and exit into markets, in terms of every decision you make. Do I take a profit or do I risk a loss for a greater profit? Trading is an evolutionary process and there are so many things to learn. It has a lot to do with learning more about yourself, not only as a trader, but as a person.

In the context of knowing who you are and what drives you as a trader, I would say that the winning strategy is learning how to pick an appropriate time frame, be selective about market entry, and also know where you have to exit. Know that you have to have a stop. Calculate your risk/reward ratio and then have a plan for monitoring it. You have to do contingency planning for what may unfold and you have to be ready to get out if you are experiencing uncertainty. No buts about it!

Additionally, five main things have to be in place to be a successful trader: preparation, discipline, consistency, fearlessness and patience. That translates into knowing your markets, doing what you say you're going to do, doing it every day, being mentally prepared for your loss or your gain, and waiting for that moment to strike.

Don't trade emotionally, even if you think the market's going down to zero and you're not on board. The process of thinking through a trade is like when you're very angry with someone and you take a deep breath before you speak. For example, the other day I walked in and saw the market had hit my projected sell level for the week and had come off nearly a point. My first impulse was to get into that market, but instead I've trained myself to go through a psychological process. The first thing I do is say to myself, "It's OK if I miss this move. I might get in tomorrow or I might not get in at all. There are thousands of opportunities in the market; there's a range every day." The second thing I do is sit down with the numbers, see what support is broken, and calculate if I can sell that old support as resistance. Where can I put my stop, and how much am I at risk? I work out the numbers, and if it seems like a good probability trade with a good risk/reward, I'll give it a try.

For me all of this came after I became a good analyst. I think it's very important to become familiar with one market and to do your homework, before you come in to trade. I go through trades in my mind and different scenarios the night before the market opens.

One thing I know for sure is never switch time frames in the middle of a trade. Never. Ever. Start off as a day trader and close it out that night as a day trader. What I'm going to say next is a bit tricky, because I'm an analyst and I'm telling you this: it's important to do your own work. Whether you've decided to get a market letter and follow that letter, or whether you've decided to follow Drummond Geometry or Market Profile or Elliott Wave, you must possess personal control of your trading. You must also never allow some off-the-hand remark by someone who you respect to change your mind about your strategy!

Doug Sooley

I was a disc jockey working in Southern Illinois, and the radio station owner let the entire staff go. So I came to Chicago as a runner to work for a trader at the CBOT. It wasn't until six months into the first year that I picked up a chart. I got a commodity perspective from one of the offices of Conti Commodities and started doing simple technical analysis. I would put in the highs and lows and the close, and I didn't really do or know too much more. I just sort of charted for about a half a year, and became fascinated by the idea of trying to make sense of the whole thing.

It's been the same way for me ever since that time. It was like figuring out a puzzle. I've always been fascinated by things like the Rubic's Cube; the market was the same way for me. Initially, it was the idea of trying to be able to predict human behavior and also seeing if there was some kind of underlying intelligence to the whole thing. At first it was also a sort of ego-feeding proposition whereby I would actually have to know what was going to happen next in the market. I was searching for the answer and I was totally convinced that there was an answer! With a capital "A."

I tried, literally, every discipline out there that proposed to give you tomorrow's high/low close etc. You wouldn't believe all the things I tried. There was Gann analysis. I was very heavily into that, squaring price and time and using timing angles to predict time points. And cycle timing work. I was totally convinced that there was a code and I was going to crack the code and I did crack the code a couple times. And then they changed it . . . after I cracked it!

I think my experiences may be very instructive to other traders, because many traders continue to approach trading this way. They feel that the market is a Rosetta Stone waiting to be figured out. I think that the need to discover an underlying code was actually the manifestation of an underlying need that I had in myself.

That understanding didn't come until after many years of trading. I started to trade, and I actually did pretty well in a bull market in soybeans, a no-brainer. I thought I had brains and was quickly taught in a matter of four months that I wasn't as smart as I thought I was. But at that point I still thought I possessed the code. Then I walked in one day and suddenly found they had changed the code on me without warning. They changed the code that I had exploded, and then it exploded me! In a lot of ways I think it's fairly typical and yet it's also my own personal story.

So I got into a pattern of riding very high and sinking very low, and then got to a point where I didn't ride high anymore. I just sank to new lows, a string of big losses that took me and a very close friend of mine down hard. At that point I would have pumped gas. I wanted to set a torch to all the years of work that I'd done. But then something within me grabbed me and shook me to my senses.

I guess what I'm saying is that at some point I felt that the search for the master strategy or for the underlying code for this whole activity of trading was an impossible thing because there is no code. But you know what? That reality still didn't even hit me until a lot later. I left trading completely for a while, and I did a lot of work on me. Soul searching. That's where I needed to do the work. I didn't need to do the work on the market. I needed to do the work on Doug Sooley. I had to find my own underlying code.

That fits perfectly into the way I think about the market today and I've incorporated these insights into my trading. Rather than trying to find a panacea for any market or the one right way, I learned that I have to trust myself and take it a day at a time. This is something that I work at consciously each day. On the best days I am aware of the fact that trading is a process. There is no finalized state or underlying code. There is just a process trying to make sense of it all in terms of statistical probabilities seen through the lens of what I believe about myself.

You may ask what my trading goals were when I first started trading. I didn't have any. None at all. I didn't even think about trading in terms of goals; I was just addicted to the energy, the emotion, of trading. As much as I didn't enjoy the lows, I loved the highs. And of course big pay days can be pretty exciting. The highs are so high, it's just too exhilarating for words!

Now I've had to work on this growth thing and growth requires some kind of balance and balance says you can't have those big highs and those big lows. So what are my trading goals today? I can honestly say that they're under revision all the time, but today I have a realistic set of goals versus what used to be almost fantasy-oriented hopes. I think I'm much more concerned today with the quality of my life rather than with the trading.

I've moved from a trading-centered life to one where I am able to keep the trading more in perspective. In the past, it was almost as if I used the market as a reliable source of getting those highs and lows. It became a drug instead of a vehicle for professional investment. The main point is that the market was serving some personal motive which had really very little to do with the market; consequently, any market strategy I devised served the wrong master. Does that make sense?

Edward Hayes wrote a book called *Sent George and the Dragon*. It's called "Sent George" because he's SENT on a personal quest. He travels into a dense forest where he meets the dragon, and the dragon says, "Don't be frightened, I'm a peaceful dragon, a Chinese dragon and I will not hurt you. If you like, I'll even instruct you in your quest." The dragon says, "Climb up on my back, and we'll go for a ride." So George gets on the dragon and notices that there are scars all over the dragon. Each time it breathes fire the scars start to glow a fantastic red-orange glow. George says, "I've noticed all these scars on you. What are they?" The dragon answers, "These are my wounds. I've been slain a thousand times but these wounds are the source of my strength. They're where I draw my energy from." George says, "I don't understand that. They're wounds."

So the dragon tells him a parable about the samurai warrior who takes his two swords and goes to meet a monk master who lives in the forest. The warrior demands of the monk, "Tell me about heaven and hell." The monk is dressed in a bright orange tunic; he looks up at the warrior's placid face, and says, "I can't tell you about heaven and hell because you're much too stupid." So the samurai warrior goes to grab his sword. He lets out a huge yell, and the monk looks up at him and says, "Besides, you're much too ugly." Now the warrior has flames in his eyes, and he raises his sword, and the monk says, "That's hell!" Startled by that revelation, the warrior suddenly drops his sword, because he realizes the strength of the teaching. He falls to his knees in humility. The monk observes this, then says, "That's heaven."

You see, we all act out of our wounds. They are our source of strength or weakness but you must have the ability to discern the difference. In my trading I was acting out of my wounds. I was trading in an unhealthy way. The work I had to do for over two years before I came back to the market was to work on my wounds, to make them a source of strength instead of a source of weakness for me. Because they had shown that they were definitely a source of weakness! It was my job to turn them into a source of strength, which is exactly what they have become.

My market strategy is to work on myself in order to produce better results in the market. My goal is to trade in a frame of mind which is relaxed, where the trading feels effortless. It goes back to what I was saying before about how I was creating a trading-centered life. Trading should be an extension of what I'm doing and not the other way around. I lived it the wrong way. I came at it from the wrong direction.

Trading is more than it appears to be.... This whole activity, trading, is more than we see, or what people conventionally accept it to be. I believe the market is a powerful metaphor for life! Although there are other metaphors, it is a very powerful metaphor. There are so many things that happen in the market that relate to what we do on a day-to-day basis, from getting up and brushing your teeth in the morning to the time that you hug your loved ones at night. It's just the way those emotions are played out in our day-to-day life, how we respond. At least this is the way it is for me today. This is how I respond as a trader to the market!

So by now I guess you want to know how this all relates to trading strategy. I can't give you a mathematical equation that you can utilize as your market strategy but I can offer you much, much more. To relate what I'm saying in a more conventional way, I believe that the best strategy is using some techniques that work for you and then sticking to a game plan. But real success in trading comes from knowing who you are and what drives you. Mental analysis, not technical analysis!

Most traders don't realize that constantly searching for new techniques or indicators is a symptom, whether it's RSI, Gann, or a new way to count Elliott Waves. People are constantly searching for something external, not realizing that the real key to trading success resides within themselves.

I know, Bob, there are going to be people who read this and think, what the hell does this have to do with the strategy of trading? They're trying to find a strategy that works in the market, and I'm talking about self-love and the ability to trust yourself, treating yourself with kindness and respect. They're going to think this is off the wall! Which I guess is why only 5 percent of traders are really successful.

For most people, it's just too abstract. You know, the more I am in touch with myself, the easier and more automatic trading becomes. I'm looking at the screen and the bond market's around 25 (11025), and I want to short it and I'm looking at the profile and I'm watching some timing stuff and the stochastics fall in place and okay, boom . . . I'm short . . . and I'm operating at that point. Feels good. No anxiety.

I'm basically saying you do have to look at the technical stuff. Believe me I know these studies quite well. Market Profile and Elliott Wave, Fibonacci, Gann, Stochastics, RSI . . . but what I'm trying to get across is the technicals won't get you there. You need something beyond all that. You need the confidence that you feel, that the way you're intuiting the market at any given time is going to make the difference. Self-trust comes from a genuine love for yourself, who you are, what you are all about. What your gift is. Without that, even if you made a lot of money in the market, which by the way is a huge "if," what difference would it make? I mean, it would be hollow anyway. I've done it. I know. I've done it from an egotistic and disconnected state. There's ultimately no reward in that! The hardest thing for me to communicate to new traders is that in trading there's no one answer. No Holy Grail. But look at some of the stuff people are selling, backed by slick marketing. And people are willing to pay anything to buy the Truth, capital T.

I would say one thing, however, about my trading: I'm looking for moves like the bonds recently, a 1,000-point move, something like that where you have an opportunity to really play that market. And the strategy is plain and simple: not to lose too much money as many times as I get stopped out just as long as I catch the big move. I just keep the long-range picture in mind.

One of the best teachers I've ever had is Richard Bergers in California. He's a fund manager, and he's been around for a long time . . . 30-odd years and he's a long-term trader. I won't name drop, but let me just say some of his friends are some of the biggest traders in the marketplace. You want to see the big picture!

Richard's strategy is the same as I was saying earlier, longer term. He might make only a dozen trades a year. And be assured he's made a lot of money that way! I'm trying to get myself more and more into that type of strategy, to take a few very high-quality trades a year and not be afraid to probe the market until the trade materializes.

The other theory is always think in terms of process rather than single trades, because a lot of people, as you know, live and die by single trades. That will kill you. I have done that, I know. So I guess what the winning strategy comes down to is looking at the process over time, sticking to your personal method, the one that works, and then being able to apply it with balance on a consistent basis, and to be able to do it confidently and to be kind and respectful to yourself whether any one trade works or not.

By the way, you're allowed to enjoy trading. You can have fun. I learned that from Peter Kelly. At first that didn't make a lot of sense to me but now I see in some ways it's almost indispensable. That's how you stay relaxed, focused. The strange paradox of trading is that the best strategy is to be aware of who you are, because if you know and understand your beliefs and your own ideas, your own wounds, you'll be able to see the market in a more objective way.

The whole thing is that the market is blatantly obvious. It always is. I mean, it's like it's a puzzle. It's not a riddle, it's a puzzle. We're always putting the pieces together and it's not like we don't know. It's obvious! Usually you know very quickly once you've entered a trade whether or not it's the right place to be. You just have to learn how to read your own internal market. If you listen, you'll know right away. If you were going to sell it at 24, and it's trading even, you know you probably were wrong, and if you're right, by the same token, usually you know too. I mean, I've heard this from the very best traders. They just know! It's like boom, you're in. You did the right thing at the right time. Nothing magical happened. You just entered at the proper place and it worked.

You do your homework. You get your methodology, you love yourself and have fun!

George Segal

To me, all of trading—and I'm saying this after 25 years of, I think you would agree, successful trading—comes down to this: Know you're wrong when you're wrong and right when you're right. If you're in a bad position, get out. And if you're in a good one stay with it until the market proves you wrong. Everybody has an ego. Every trader has an ego; but the people with the big egos who cannot realize that they're wrong or right are in big trouble!

I think the main issue in trading is the ability to take a loss. As you know, people deal with it in a lot of different ways. I mean, some people trade with complete abandon, like they're in a state of denial. They just refuse to look at the loss. Other people talk about not being able to pull the trigger, like if you don't do it you won't lose. But guess what? If you don't trade you feel lousy. You pay for it anyway.

My take has always been that if you're wrong, you can always go back and do the position all over again once you're out.

But that's the block. Many people find that when they get stopped out of a position, usually at the very end of a move that goes against them, they cannot pull the trigger to get back in. That's their problem. And that's the problem for 80 percent of the people who trade. It's never been my problem because I like the excitement of being in the market. If I'm right, I know what to do—let it ride. If I'm wrong—you know I'm out fast!

You've got to have a good strategy. I always felt that knowing something about the fundamental makeup of the markets and combining that with the technical aspects is good, because when everything's in sync, one takes the bigger positions. And when things are not in sync, one takes the smaller position.

Basically, I'm a fundamental trader. I have people in the livestock industry that I consult with, who help me form my analysis, and then, of course, I consider the technical makeup of the market, both the monthly and weekly charts, not the short-term chart, and then of course I look carefully at the open interest of any given market.

I'm sure you want to know how I know when to enter the market because, obviously, there are a lot of people that do fundamental analysis, and their timing is way off. Of course that's where the art of it comes in. Even so, I may exit two or three times before I really take a position. I don't know. Sometimes I do it once, but generally it takes many more times than that before I feel comfortable.

I think what makes me different is that I'm willing to probe a market as many times as it takes. That's a unique concept to most people. Because most people get shut out by the market because they tried it once, or they tried it twice. Usually they just give up at that point. So I think that's a fairly rare quality, to keep coming back, to keep knocking on that door until it opens. Also, I'm willing to change my mind.

I want to talk about money management. It's critical but, strangely enough, I don't have any particular formula. When I'm comfortable with the position I stay; when I'm not, goodbye! If I can't sleep, I get out. It depends on the market. It's not a dollar amount.

I'm telling you that you would not believe how simple my strategy is. I've been in this business a long time and I don't know what an RSI is. What's a CCI? Basically, I'm looking for a long-term trend in the market. If you look at the current livestock charts, they tell me we are making a top, along with my bearish analysis. It's also true that this year's market is very unusual in hogs, because of the gigantic premiums that the futures have to cash. Bottom line, all of that indicated to me that the odds are you had to be short.

I thought that the probabilities were 90-10 that the market could never achieve the premiums that the futures had anticipated. The open interest had built up to a very large number, and by the way, it's still very large, which makes me more convinced that these June hogs are going even lower. But remember, I like everything to be in sync. I like a contrary point of view, because I think that's where the biggest moves come from. Now, of course, you don't always get a contrary point of view that works.

But this year's hog market was easy . . . . Every single person in the world had an opinion. It was the most publicized bull market ever . . . and so it broke 700 points: It had to!

For me this is the ideal trade. Obviously you can't always find that situation, but when you have this situation you must try to capitalize on it. Remember what I said before, when you're right you must know you're right and act accordingly. I had one of the biggest positions I ever had, because I felt comfortable with the liquidity of the market. It was easy getting in and getting out. You see everything that I'm telling you gave fuel to my strategy. It was a very liquid market, and the fundamental analysis provided important information: the premium of the hogs over the cash, plus the fact that everyone was bullish on this market. The premiums in the options were there for the taking. Everything indicated to me that being short was the right position. There was no open interest in the puts, which of course meant no one wanted to be short. And there was the market ready to nose dive after all the weak longs were finished buying.

So I guess I'm saying that my strategy, basically, is to analyze a trade on a fundamental basis and look for technical corroboration of my point of view, but always in the context of the long-term chart pattern in the market. When the market breaks the long-term trendline one way or the other, I will always have a major position.

By the way, even though I was bearish, I was long the hogs when everyone else was buying. I was long all of December and January but I knew that the trend was changing. However, my fundamental analysis never allowed me to be bullish. So I know what you're wondering. Everything told you the market was about to break, but you were buying them with everybody else when the market was going up. Why? My answer is simple. Because I wanted to make money, and the market was going up! And we were seeing fund buying and open interest hadn't fully built up and the premium still wasn't there. I had an obligation to fulfill my economic function and so I got long!

I was always comfortable with the long position because I didn't have a big enough position to make me uncomfortable. I knew where I would get out if I was wrong. Again, I think that most people find this way of trading to be kind of startling, because most people feel that unless they feel that bullishness or bearishness right down to the bottom of their toes they can't get involved in the market. But for me it only boils down to a question of the most efficient way to make money. And you know how you can tell if you're efficient? It works!

One of my trading traits is my willingness to let the market tell me what direction it wants to go. Now, if I'm wrong, I'll get out. But if the market feels like it's going to go up, and I'm not bullish, I might still buy lightly, because the market feels like it wants to go up. In late January and February of this year we had tremendous weather problems. The market was going up, and everybody was bullish. So why not participate?

I want to say something about how to get out of a position. There are two ways of getting out of a market. There's getting out of a winning position, and then there's getting out of a losing position! Obviously when getting out of a winning position, one doesn't need a lot of help. You use every prudence. You take partial profits. You take additional profits. When it reaches a point where you think it's gone beyond where it should go, whether the open interest has been cut or not, then it's time to exit.

I also want to deal with an issue that's a side issue of this. What do you do if you're in a market where you have profits built up and you haven't decided that it's finished and the market starts to rally. You ask yourself how to deal with watching your built-up profits start to dwindle. It's the age-old problem!

I say to myself, "Be careful. Be careful." You know I watch the position. I talk to people. I really study what's going on in the market. I look at the technicals more critically. But overall for me it comes down to exactly this: Where do I feel uncomfortable?

What I also find very interesting is that for me the biggest markets, the biggest profits, have almost always been sort of surprises, because you start out having a negative position, and then the market is going down fast. Gravity is working for you full-time.

It usually goes something like this. The market takes out the trendline. Then, a week later, you start saying to yourself, my God, this thing looks a lot worse today than it did before. . . . I mean, there's all kinds of negative market news. So I'm saying to myself, "This thing looks a lot worse today. I've only got 300 hogs on. I've got to have 500 hogs on." But then, a week later, we break the trendline, you know. First you break and now fundamentally this thing is looking sick to me and then we break a longer-term trendline. Now I'm short a thousand hogs, okay? And all of a sudden, things start to roll! Well, when you went into the position, you did not necessarily anticipate that, because the market's been jerking around up and down for five months, but here we are. Of course, I have to add one small detail: Before I got short in the first place I might have been stopped out a few times. And as I've said before, most people won't do that. Most people take their one shot at it or their second stab at it and that's it. Part of my strategy is that I'm constantly testing the market.

When we went through that trendline, I'm doubling the position, and when we cross over it I'm out. You see that's important; I think that is why I'm a long-term trader. I don't screw around with what's going to happen today, or what's going to happen tomorrow, because no one knows. That is crazy; you could lose your mind doing that! That is precisely what messes up a lot of traders. They look at the very short term, like today or tomorrow or even this week. But you need a lot of those people. Everybody can't be a long-term trader, because then you've got no one to trade against and I wouldn't want to see that happen.

I think the ultimate winning strategy is to figure out a way to control your losses. Figure out some way that you're always controlling them and stick to that rule. When I go into a market, I always have a place where I am going to get out when I'm wrong, because I'm always thinking about the possibility I may be wrong. I'm not really worried about the other side. The other side will often take care of itself if you believe in yourself and your analysis and your strategy.

I've also always been a big believer in the 30-day moving average. I try to use that also as a guide. The closer we get to it, the easier it is to sell. Say we close above it for two days in a row. . . . The second day I'll get out. You see here again why you need a strategy. If you're a trader, other than a day trader or a scalper, you've got to devise a strategy of where you're going to get in or get out. And be able to feel, yes I know I've said it before . . . comfortable.

I'm always looking for the big play, the big move. It's taken me a long time to learn how simple the whole thing really is.

Marshall Stein

What I enjoy most about trading is the whole process of putting together an effective strategy. It's exhilarating to have a plan and watch it come to fruition. And interestingly enough, I don't know if anyone has said this, but the way you feel about the market is always an idea that matches your personality. You regulate the numbers and build the position day after day, week after week, to the point where it becomes remunerative to you. Now that's happiness!

Personally I think I have an inordinate amount of discipline. I'm not a person who goes for the kill; I'm not a make-it-or-break-it type of person. I've always played cards but I'm not really a gambling-type person. If I feel I can put myself into a position where I have some sort of an edge, a feeling of confidence, then I feel pretty good about it and I'll really go for it.

I want to say something about discipline because, as you know, it is key. I think that it starts with some people as just part of their personality, as part of their nature. It's possible for some people—who may not have that characteristic initially—to acquire it like a skill, to develop it. Sometimes traders have to have some pretty hard knocks before they learn to develop it. In my own case, I've always felt that I have a proper amount of fear for markets and a respect for what the markets can do to and for you. Overall, I'd have to say that it comes naturally for me.

Before you even begin to think about trading strategy in the conventional sense you have to have an understanding of yourself. You must know how you will react in a pressure situation. As you know, your psychological makeup more than anything else affects your strategy of trading, and this all gets right back to discipline.

Hey, almost everyone can take a loss. Truthfully, most people don't have any trouble getting out of the market with a loss. You know the old adage, love to take a loss and hate to take a profit? Most traders in my experience, including me, have a problem with letting the profits run. If I get into a near loss situation or loss situation, well, I'll come right out of it but developing a strategy to deal with the profit—now that's something else!

As you know, over the years I have owned three FCMs [brokerage houses]. I've had the opportunity to watch the progress of many traders and, of course, many traders who were on my daily run. Why do you think so many traders have this inability to develop a plan or a strategy that allows them to attain consistent levels of success? I think the answer is nobody likes to take a loss, and the worst thing anybody can do is take a loss at the bottom. Every trader's worst fear is getting out at the bottom, and five minutes later the market's going to rebound and he would have been right. So what this situation requires is the discipline to set a stop-loss point. You set a place where either you're stopped out because the chart says that you should be stopped out or you're stopped out because you allocate a certain amount of money for that trade. At that point the risk becomes more than the possible reward!

So you should be able to stop yourself out. But human nature is that you get to a point where you don't want to be stopped out so you give yourself a little more room. The next thing you know, something else happens. For example, a person gets into the market and it's right near his point or goes to his point and the session ends. Instead of getting out at that point, he waits until the next day. The next day, the market opens sharply lower. Well, he's not going to get out then, because he didn't get out where he was supposed to get out . . . he says to himself but maybe it'll come back. And that's where people who should be fearing are hoping. Whenever you start hoping when you should be fearing, you have a problem. But as I said before, taking a loss is still not half as hard as taking a profit. When do I get out? How do I repress the voice inside of me that just begs me to get out? "Get out you fool, you want to give back all those profits?" You ever hear that voice ringing in your ear?

I also find that you have to find a niche in trading. If you can find a market that is comfortable for you, dealing with people that you feel you can trust, you can enjoy it. And by the way, enjoying it is very important; how successful are people at things they hate? Frankly, in recent years I've found the markets I've been trading, to be a little more difficult to trade than before. In the past, I tended to trade distortion, meaning that I would be spreading in a particular market and the order flow would produce a distortion in the spread, throwing it way out from where it had been an hour or two ago or even a few days or weeks ago. The idea there was that I would fade the distortion, a distortion of value with a mental stop-loss point where I was wrong. If the market kept moving out but did not surpass this point, I would put on a scaled-up position until my position limit was fulfilled.

By this point you may be wondering how I chose spreading as my trading strategy. Well, in the first place, I believe spreading gives you a little more time, but I do want to clear up one other thing. When I talk about value . . . value as reflected in the distortion has something to do with it, but that's not the main factor for me. When I'm spread scalping, that is to say I'm trading the distortion off of what I consider to be unnatural order flow which pushes the spread out of its normal equilibrium. Eventually, or I should say usually, you'll find that the spread will return to near where it had been earlier. . . .

The trader primarily watches the pattern of the spread, through charting or other methods, and watches the pattern in different time horizons (an hour, a day or a week, etc.) That's how I determine what is distortion, and when that occurs, I try to take advantage of it.

You see, it's very important to have a specific, focused strategy because, otherwise, you're kind of wandering around in the dark. You're operating by the seat of your pants, trading randomly, even though you may have a success here and there. In the long run, believe me, without a well-planned, well-executed trading strategy, you are going to take some pretty substantial losses. I myself started out as a scalper, and I still do some of that. I still scalp here and there. Sometimes I'll put on a leg of a spread, for example, and have an immediate profit, which might be as good or better than I had expected to make in the spread, so I'll take that profit. But in a spread, sometimes you'll find, at these distorted times, that one leg of the spread will be going down and the other going up. That gives you a double reason to put that position on. In other words, I found that spreading widened my options to trade the market. Spreading also allowed me to spread off the risk. It was a way for me to manage my money in the market and not get down on myself psychologically, which I said before is the most important factor.

Spreading also gives you more time and allows you to expand your psychological tolerance. If you have an outright position and you are wrong, you just get out; whereas, in a spread, you can sit out those distortions for just a little longer, in my experience. You can get a second look, so to speak. Of course, bottom line is, if I'm wrong, I'm out! In my case, using a spread was in effect a way for me to trade the market in the face of new information or reports or some momentary change in the market which would otherwise make me feel uncomfortable with an outright position.

Let me take you through my whole trading strategy. In a nutshell, what I'm doing ideally is looking to spread with the trend when I see distortions in the market. The big money is made with the trend when you're trading for any long term. But many times when you're scalping, the money isn't necessarily made in the direction of the trend. Of course, what I'm saying to you sounds completely contradictory.

I'm always watching a trend and trying to be with the market as it's moving along on a trend basis. However, now I am observing, trying to determine if it has reached a level where there seems to be a range and the spread is trading in a consolidation pattern. Once I have established that range, the idea is to buy against the support, the bottom of the range, and sell against the top.

Let's say the spread in the cattle market may be between 100 and 200 points. When the spread comes down to a 100 points, you want to buy the spread. When the spread goes to 200 points, you want to sell out and also possibly go short. So basically I'm trading the spread on its extremes as I perceive them because I feel I'm fully aware of the history of the spread, in effect, from my analysis of the spread. I'm always aware of where the spread has come from, meaning what the historical parameters are on the spread, and what the future possibilities are. And you know what? I still make a lot of losing trades. That's where the risk control comes in! You must do your homework in regard to these things to get an idea of the chart patterns that are before you.

Before I get into any trade in any market, I know exactly where I'm going to get out, and I've already determined what the risk/reward ratio is, and that determines a great deal of the way I'm going to get out. In gross terms, I have established that what I want to make is three times or four times what I risk. If I'm not going to make exactly that because there is a chart point right under that or there may be some fundamental information that comes into the picture, then I will of course, allow myself a little more leeway. But generally speaking, I will know where I'm getting out before I get in. And I always try to do that. It's taken me many years, over 20, to be able to do that!

I'm not a psychiatrist or psychologist but it seems to me that many traders like to gamble—and I've known many, many traders over the years. If you're going to gamble, you're going to have a tough time in these markets, because that means you get a thrill out of going against the market. In your mind you want to kill the market. Well, the market will carry you away. There is also the factor of greed. If you are so greedy that you're going to try to milk the market and get the last cent out of every trade all the time, you're going to have a problem. Fortunately I don't have either one of those characteristics.

I have watched a lot of traders in my career, and I've known personally some of the really great ones. I have watched a lot of people come in with very little and make vast fortunes, but it's very difficult to determine who's going to be a good trader. In fact, often you don't know exactly the reason for any single trader's success although you do have an idea about it. And I have ideas. What stands out in my mind is this: The most important thing is that your trading strategy must be tailored to your trading practices according to your own personality. That's exactly what I did in the early years. I looked around at who was doing what and began to develop strategies and techniques that made me comfortable and that were within the comfort zone of my personality. Believe me these were the things that would make money for me! Whenever I tried to follow someone else's strategy or style, I would immediately get into trouble.

Let me speak now from the perspective of being a director of the exchange. We have people here who follow the trend, which is conventionally supposed to be the best way to trade. We have people who go against the trend. We even have people, and I won't mention any names here.... One of the best examples in our whole industry is a man who just never seems to get out. He gets in. In fact, on the surface of things he actually goes contrary to all of the things that we've talked about and yet he is one of the most consistently successful traders in this country. He's a fundamentalist and he establishes a position with information that he gathers personally and he's said to me, "When I go into the market, I'm 90 percent sure of myself." Well, that's very nice, and the fact is that he intends to be there when the cows come home, because he knows he's not going to get out that easily once he's in there. And I've seen him stand there with gigantic losses, many, many millions of dollars and come out of those positions, with an equally large profit. Well, it should be obvious that anybody who follows him, who does not have his personality, is going to find himself in real trouble . . . because a follower is going to be getting out right at the bottom while he's still staying in there and maybe even adding to his position. And you don't know where the bottom is, and neither does he, but he has a personal trading strategy for what looks like madness. Simply put, his plan is, I'm going to stay in there until I'm right in the face of the fundamental information I've researched and determined to be correct. So in actuality his success is that he knows precisely when he's wrong. He believes that he's wrong only when the fundamental outlook—as he sees it—changes significantly. As he sees it!

I think many traders today are not successful because they purchase systems or software or apply trading strategies that aren't suited to their own particular personalities. They can't implement them and they feel lousy.

Getting back to the discipline: A man can be fairly well disciplined, but he gets into a system or strategy that's contrary to the way that he feels and thinks. It is alien to his person, and, therefore, he just cannot deliver.

The other issue I'd like to address is consistency. Consistency comes from confidence in what you're doing. If you're confident in your strategy and you've traced it back over years and years and see that it works, and you know that there are of course times when things go against you a little bit, but you don't let that prevent you from executing. . . . If you've seen how it can work, then you can be confident in yourself and your strategy and thereby achieve consistency. Even in the face of adversity you can consistently maintain whatever strategy you're using.

When I started in this business, there were just a few books of a serious quality available about the markets. Today there are many, many books and tapes and seminars which provide you with as much information as you can want with regard to the markets, everything from different types of analysis of strategies and tactics to ever more inventive ways of gathering and using supply and demand factors and that type of thing. There is also a never-ending stream of information about chaos theory and artificial intelligence and the like. However, the absolutely most critical dimension of trading, and the least discussed, is the psychological side of the market . . . yours and mine! I've always felt—and over 30 years of experience has just reinforced my belief—that this is a very, very important area. In the early days I had many offices and we used to give seminars sometimes for a week at a time all around the country. One of the things that I always stressed was the psychological aspects of the market, to try to figure out what the other people are doing and thinking, and apply that information to your own trading.

However, before you figure out what the other people are doing, you better know damn well what you're thinking in your own mind.

That is primary, and you have to try to keep your mind clear in order to focus. It takes tremendous concentration. It's easy to say, but it has taken many years to be able to do it. . . . To keep your focus is important to your strategy, to be able to implement it knowing full well what the probabilities will be over time. If you don't have that in your strategy, it's going to fall to pieces!

So where does that confidence and belief in your strategy come from?

It comes from studying things that have happened in the past, studying the markets and doing a lot of research as to what these patterns are . . . but this is the small part of your trading strategy! The philosophers from time immemorial have told us to know ourselves. Sounds easy, doesn't it? This also applies to your trading. As you know, I've been trading now for over 30 years, and you know what, I still love what I'm doing. I love to trade. I love it when the markets are compatible to my methods and strategies of trading. I find that in some markets there have been tremendous changes, and therefore I have to move around to find new markets that I can apply my own strategy to. Luckily, the challenge is still important to me and, as I mentioned before, I'm also having a lot of fun.

If I didn't enjoy it, I would of course, be doing other things.

But the key always is this: Find a strategy that works for you, gain confidence in that strategy, and stick with that strategy. I know that you will be successful!

Chapter Five

Staying in Control

Mark Douglas and Charles Faulkner are internationally recognized experts on the psychology of trading and investment. We have observed both of them conducting seminars and workshops and have had the opportunity to serve with them as speakers at major trading conferences. Their insights offer a great deal to traders at every level of professional development. Each possesses a unique orientation about trading psychology and reinforces the idea that only through a deeper understanding of oneself can trading performance ultimately be improved.

Mark Douglas is president of Trading Behavior Dynamics, Inc., a Chicago-based consulting firm that works with individual traders, CTAs, and brokerage firms internationally. He is the author of The Disciplined Trader.: *Developing Winning Attitutudes."*

Charles Faulkner is a certified NLP [neuro-linguistic programming] trainer. He is co-author of the video programs "NLP: The New Technology of Achievement" and "NLP in Action." He was interviewed by Jack Schwager in New Market Wizards *(New York: Harper Business, 1992) for his modeling of futures traders.*

Mark Douglas

Q: Mark, what first attracted you to the markets?

Mark: That's a very interesting question, and surprisingly difficult for me to answer.

Q: Why is that?

Mark: Since I started trading in 1978, I have changed so much that it's difficult for me to go back and specifically state why the person I was at that time was so attracted to the markets. What I say in my workshops is that at a very fundamental level we are naturally attracted to the markets or trading because it offers us unlimited freedom of creative expression.

Now, if you were to say to me—is that why you started trading—not having thought about it in that context back then, I would have to answer "no," it was probably the money or the possibility for achieving financial independence. However, isn't financial independence in many ways considered synonymous with the freedom to express ourselves?

Q: It's interesting that you mention creativity, because we've heard that often from the top traders that we've interviewed. Could you talk a little bit about how you feel you've changed. In what ways has Mark Douglas changed?

Mark: I've changed in ways that are far too numerous and personal for me to go into, considering the limited scope of this interview. In other words, I could write another book on the process I have gone through since I started trading to become the person I am today.

Q: Well then, give me an example of just one of the ways you have changed.

Mark: When I first started trading, I was selling commercial property casualty insurance. The idea of writing a book or being an author, developing material on the psychology of trading, conducting workshops, and being asked to speak at investment conferences around the world was about as far away from my self-concept as it could be.

Q: Initially, before all of these changes took place, what was it that fascinated you about the markets? Was it the money?

Mark: As I already mentioned, money was certainly a part of my motivation or fascination to trade. But I would also say that curiosity and the intellectual exercise of figuring it out was also a big part of it.

Q: As you think about the whole process of trading, and I know you've worked personally with many traders (some very successful), what do you think are the essential characteristics of a successful trader?

Mark: When you use the word "characteristics," that implies to me there are some inherent characteristics that a person has to be born with to be successful. I don't know of any such characteristics.

Q: Is "qualities" a better word?

Mark: We can use the word "characteristics" as long as we separate it from the association I just mentioned.

Q: You mean as a natural endowment.

Mark: Yes, there are certain characteristics of a mindset that I believe are essential to creating success in the markets or creating consistency. To me, success as a trader is consistency. There is an often-used saying on the floor of the exchanges that "traders just rent their winnings." As you know, there are many traders who have reached the stage of development where they can put together a substantial string of winning trades, days, weeks, or even months, only to lose all or most all of their hard-won equity in a few trades and then start the process all over again. If a trader hasn't neutralized his susceptibility to give his winnings back to the market, then he is not what I define as a successful trader.

Q: In your opinion, what is the mindset of a successful trader?

Mark: There are many components that contribute to this mindset. The most fundamental of which is accepting complete and total responsibility in their trading.

Q: How do you mean that? In what respect don't traders assume responsibility?

Mark: There are as many ways of not assuming responsibility as there are traders. The most obvious is any inclination to blame the markets for one's unsatisfying results. When we as traders blame the markets for not ending up with what we wanted or expected, we are assuming that our results are externally generated instead of 100% internally generated.

Q: That might be a difficult statement for some traders to swallow. Will you elaborate?

Mark: Certainly! All of us have a relationship with the markets. Most relationships imply two-sided or two-way interaction. However, this is not the case with the market. Most traders have absolutely no control over the market's movement and by the same token, the market exercises no control over the trader. From each individual's perspective, the market just generates information about itself and gives each trader the opportunity to make a successful trade on his own behalf. Now, if the market has no control over the way in which a trader either defines or interprets that information, nor any control over the way a trader expresses that interpretation through his trading behavior, then where do the results come from? I teach traders that their results are a function of the number of distinctions they can make in the market's behavior, the quality of those distinctions, and how well they can act on them. I probably don't need to point out that all these functions are internally, not externally oriented processes.

Q: When you talk about distinctions, traders are making all sorts of distinctions all the time: I mean, they look at the fundamentals; they look at technicals and yet, it seems to me, that the more distinctions they make (we hear this many times from traders that we've worked with) the less success they have at trading. And so, I want to ask you, how does that fit in with your last statement?

Mark: I know it may sound strange to many readers, but there is an inverse relationship between analysis and trading results. More analysis or being able to make more distinctions in the market's behavior will not produce better trading results. There are many traders who find themselves caught in this exasperating loop, thinking that more or better analysis is going to give them the confidence they need to do what needs to be done to achieve success. It's what I call a trading paradox that most traders find difficult, if not impossible to reconcile, until they realize *you can't use analysis to overcome your fear of being wrong or losing money*. It just doesn't work!

Q: If that doesn't—what does?

Mark: Learning to think in probabilities. Thinking in probabilities requires a fundamental shift in our understanding of the nature of the market's behavior which causes us to think in more positive ways about losses or being wrong. For example, the collective actions of traders interacting with one another, basically doing the same kinds of things over a period of time, produces behavior patterns. These patterns are identifiable (we can see them or hear them), they are quantifiable (we can measure and put them in some sort of meaningful context), and because they are patterns, they repeat themselves with statistical reliability. But there is one key element to all of this that really screws up everybody's thinking, which is also another paradox of trading. Yes, the patterns repeat themselves but the outcomes are random. And that's why analysis will never give a trader the confidence he needs to be a consistently successful trader.

Whether they are aware of it or not, most traders use their analysis to avoid being wrong or avoid losing. They study the markets very diligently, they "put in their time," only to be betrayed—time and again—by a market that sets up a pattern exactly like the last time, but doesn't follow through.

Unfulfilled expectations cause emotional pain and no one likes to feel that way. So to avoid the pain, the trader naturally assumes that if he adds more variables or filters, he can prevent himself from being wrong or losing. Each time this doesn't work, it erodes his self-confidence. By learning to think in probabilities, we are taking trading out of a right or wrong, win or lose context, at least with respect to the emotional pain associated with being wrong or losing.

Q: So, not only do we have to understand how the markets work, but first we have to understand how we work.

Mark: Absolutely! This is the principle reason why achieving consistent success as a trader is so difficult or elusive. We aren't dealing with tangibles. In the normal course of our lives we have learned all kinds of strategies for making the external environment look the way we want it to or expect it to. Most of these strategies involve some means of force, manipulation or control. The problem with trading is that the markets don't respond to our attempts to control it. As traders, the only thing we can control is ourselves, meaning our mental perspectives and our behavior. And most people have no concept of what it means to control, alter, or manipulate a mental perspective.

Q: An example being not having an expectation of the markets' behavior?

Mark: Yes, exactly! But this presents traders with another paradox. "How can I know what to do if I don't have an expectation?"

Q: Well, that was my next question. How can you do anything effectively if you don't have an expectation?

Mark: It just depends on what you expect. Which is the essence of learning to think in probabilities. Instead of expecting this next trade to work, you expand your definition of success to a series of trades or a reasonable sample size of trades. A sample size large enough to adequately test the variables of your methodology.

Q: Now in my experience, that's a very scary enterprise, because, then, you sort of face the stark reality that your system might not be working. It seems to me, most traders like to operate in an environment of ambiguity, personal ambiguity. I don't know if that's true with your experience with traders as well.

Mark: Absolutely. As a matter of fact, Bob, what you just said relates to exactly how we started off the interview. As traders, we have to assume that we are 100 percent responsible for all actions. And any trader that separates himself from that responsibility through ambiguity or anything else is doing just that. In other words, they don't want to take complete responsibility for the results. And so they have any number of mental games that they play with themselves for that very purpose. Now keep in mind, if we've defined consistency as success, any approach that's not methodologically sound will not produce consistent results. It can't!

Q: Well, that's very interesting, because traders come to me all the time, and they talk about the random nature of the market, and almost all infer from that that they need to respond to the randomness of the market in a random way, and that obviously is not a winning solution.

Mark: Absolutely not. What traders really don't understand is that the randomness is in their own mind, based on their approach. It's not in the market. Markets do offer us repeatable patterns.

Q: Can you talk more about that, Mark? I know when Howard and I conduct workshops, we often say that the market is a giant Rorschach test, and in fact, it's even more than that. The market is like a Rorschach hologram. It's not only something that you see, but it's something that you hear. It's something that you feel, and it's something that is constantly affected by your beliefs and motivations. It is your internal reality, which dictates results.

Mark: Exactly.

Q: Would you elaborate on that point. I know it's something you've written about.

Mark: What I teach traders in my workshops is that what they experience in the market, meaning what they see and hear or feel in the market, is essentially a mirror of their own mental environment. And it can't be anything more than that! For example ... Think of the very first time you looked at a price chart, if you can go back to that moment, what did you see?

Q: I just saw a bunch of random lines.

Mark: A bunch of random lines. And now, if we could magically reproduce that first chart you ever looked at, what would you see?

Q: I'd see patterns. I'd see opportunities.

Mark: You'd see opportunities to create experiences of satisfaction by putting on a winning trade.

Q: Exactly.

Mark: So what's the difference between the first time and now?

Q: My perceptual field, my knowledge base . . . as you're talking, you're reminding me of driving down a street and passing a restaurant, and before I took my wife for dinner at this restaurant, it was just another storefront. But now when I pass by this restaurant, I say to myself, "Man, what a great place to go for dinner!"

Mark: Exactly.

Q: And, if I understand what you're saying, the more you look at a chart and the more you open up your mind to the meaning of that chart, the more attractive this dining opportunity appears.

Mark: Exactly! So, really, what you see in the chart now is simply a function of what you've learned, isn't it?

Q: Yes.

Mark: What you learned about this new restaurant . . . caused it to take on a different meaning in your mind. Now, let me ask you, when you look at a price chart, do you think that you've learned every possible distinction? In other words, have you learned every possible relationship that exists between the component parts of that chart in a way that might identify a pattern or opportunity to do something?

Q: Absolutely not. In fact, there are traders who come into my office all the time and point out to me how very little I do see in that chart, but I will say that the fact that I don't see more in that chart will not determine my results as a trader.

Mark: I'm not implying that, but I am using it to make another point. The point is this: What we haven't learned yet is invisible, isn't it? Again if we take the very first chart that you looked at, there were opportunities there that were invisible to you. So now let's get back to the original question of responsibility and how it's all happening inside of our mind. Whether we're looking at a screen or down on the trading floor, we are not experiencing "the market." We are experiencing our interpretation of the market based on what we've learned. In other words, it's just reflecting back to us what we know about it, what's inside our mind and nothing more.

Q: This concept of the market as being a personal mirror is a fascinating concept. I think it has a great deal of validity, having traded both on the floor and for the past few years in front of the screen. It does raise a question in my mind. Is there a market? Is there such a thing as an objective market?

Mark: There would be an objective market to a person who could make every possible distinction available from the market's perspective.

Q: But after the trading session, we tend to say, "What a day in the market," or, you know, "Wasn't the market really acting a certain way that day?" What I'm asking you, Mark, is when we're saying things like that, are we referring to the same thing?

Mark: Yes, but this is more of a philosophical question than anything else. If you can accept the premise that what we haven't learned yet is invisible to us, then everything else is available. It was there. It was part of this, let's say, objective reality, but how much of that objective reality I experienced through my perception is a function of how much I've learned. Everything else is literally invisible so all other opportunities to do something, based on the information that we haven't learned to perceive yet, because we don't have the internal structure to perceive it, might as well not even exist at all. But yet it does exist!

Q: How do we enhance that internal structure? How do traders develop the ability to make those higher distinctions that will ultimately ensure a positive result?

Mark: That's a good question. One must learn how to trade from a relaxed state of mind. If you can create an internal environment . . . where you are completely relaxed as a trader, where the market can't offer you anything that you would interpret as being painful or potentially painful, and losses are painful, being wrong is painful, missing out is painful, leaving money on the table is painful. When you've learned how to redefine in your mind all of these potential interpretations of market data that would elicit pain, then you will be in a relaxed frame of mind, or a confident frame of mind, where you are open to learn. When you're not in a relaxed frame of mind, the learning process shuts down.

So essentially what you are asking me is how do people learn? People learn when they're confident and relaxed. When they're in a state of fear, they're not learning. As a matter of fact, they shut down the learning process and they can't even perceive what they already know.

Q: It's interesting that you mention that because the most often heard complaint that traders come to me with is that they have this high level of fear, and the cliché that we hear most often is that traders don't have the ability to pull the trigger. They talk about not having the confidence to act out on their good judgment or their higher distinctions within the market. How do you respond to that? What do you tell traders that come to you with that kind of complaint that they're just afraid to get involved in the market?

Mark: There are a number of techniques that I give traders for working through these fears; however, at the most fundamental level, it's still learning how to think in probabilities. When you've actually created a mindset that acts upon your perception of market information from a probabilistic perspective as opposed to am I right or am I wrong, am I going to win or am I going to lose perspective, then that fear doesn't exist anymore. You've taken it completely out of the context of those fears.

Keep in mind that when I refer to living and dying on the next trade, basically what I'm referring to is that next trade isn't just a trade. If I'm afraid of being wrong on that next trade, it traps me into this mental framework of all the times I've been wrong throughout my life. That's why it takes on such a great significance. And trading can't take on that kind of significance for you to do the things that you need to do for yourself. In other words, for you to exercise your trades properly, it just has to be a trade, not an association to every time I've ever been wrong in my life, or every time I've lost something of real value in my life. And if I'm making these direct associations, it's little wonder why I can't do what I need to do for myself. Even though I may perceive this as being a great opportunity!

Our fear not only shuts down our perception of information, but it also immobilizes us physically so that we can't act in our own best interests.

Q: So how does one develop confidence? How does one overcome the fear? I know you mentioned thinking in probabilities, but, you know, there's always a distinction between knowing what to do and then doing what you know. How do we get someone from a position of knowing to think in probabilities to actually being able to act in probabilities.

Mark: Well, Bob, this is really the essence of my workshops and I want to give you an answer, but what I want you to consider is this, that some of the simplest things in life are often the most effective. And the technique that I use to get traders to release these fears are, in fact, really quite simple.

Q: Simple, but not easy.

Mark: Yes. Simple but not easy. Correct. Very simple techniques and exercises. Not easy. But at the same time, it still takes me a full 2-1/2 days to get people to the point where they understand the truth or . . . just say understand the effectiveness behind the simplicity of the truth. . . . So that when they walk out of my workshop, there is no question in their minds that they will do these exercises, because it is an essential step in the evolution of their becoming consistently successful traders. These are traders, in some cases, who have even been in the business for 25 or 30 years, and they will actually walk out of my workshop and commit to doing these very simple exercises that they would never have considered doing when they walked in 2-1/2 days before.

The essence of these techniques is that by the time somebody leaves one of my workshops, they understand that they don't have to know what's going to happen next in the market to be successful.

Q: What does this imply for all the people who are out there who think the essence of trading is forecasting the next big turn in the market?

Mark: I think that goes back to the very nature of trading. Markets produce the collective actions of traders interacting together on a moment-to-moment basis. Patterns repeat themselves with statistical reliability, and each pattern has a random outcome. That is the paradox! . . . Meaning that, you don't know, and I don't know, what's going to happen next. It's that simple. Now the problem is that you've got people that have been in this business for 20 years and still analyze the market and still try to think or try at least to indulge themselves into thinking that they know what's going to happen next. And as soon as you tap into the mindset of, "I know what's going to happen," you start tapping into a whole set of mental structures that will cause you to see and behave inappropriately as a trader, or at least inappropriately relative to your goals of creating consistency.

Q: So, what you're saying is, in essence, that by coming to the paradoxical realization that you don't have to know, you will know.

Mark: You're absolutely correct. It's by coming to the realization that you don't know that you will, in fact, end up knowing. You'll know what to do next in any given moment, and that's the key.

Q: It sounds like a Zen koan and I'm just wondering if you can elaborate a little bit more . . . not in terms of specific exercises, but how is that possible. I mean, most people think, well, if I don't know, if I realize I don't know, that just places me in another situation of lacking knowledge.

Mark: Not true. When you understand the statistical nature of probabilities, then you are in a state of knowing. What you don't know is what's going to happen next. But what you will know is what's going to happen over a certain number of samples, and over a certain number of samples, your methodology will produce consistent results.

Q: So in terms of the development of successful trading strategies, how does this knowledge help you develop an effective strategy for trading markets?

Mark: That's a good question. The strategy paradoxically is really not the key.

Q: Mark, let me put it another way. How important is having a well-developed trading strategy to becoming a successful trader?

Mark: Bob, answering this question is at the very essence of what I'm trying to communicate in this interview. You definitely need a good methodology.

Q: A good strategy.

Mark: A good strategy. You have to have a way of identifying an opportunity. You have to know what an opportunity looks like, feels like, or sounds like. You have to know when it's not working. You have to know when it has worked. But . . . how do you make a successful trader?

That's exactly what I'm trying to communicate here. I believe this is a very small part of what it takes to be a successful trader and, maybe much to the dismay of many traders out there, probably the smallest part! It's important, but it's not that important. You need confidence, discipline, focus . . . that's what's going to create the kind of consistency that you need, the kind of success that we defined as creating consistency. In other words, that consistency comes from within in terms of your own internal structure and your ability to do what's always in your best interest at any given moment in the market. Now that can mean a lot of different things to a lot of different people, because everybody's coming to the market with a different set of attitudes, a different set of beliefs and memories that will cause them to act and interpret information in a variety of ways. For example, you can't create consistency as a trader and be addicted to the market. It's impossible. How could you? Because there will be times when you should not be trading, and if you're addicted to the market, you can't make that choice. You're in a state of choicelessness. At those moments when you should not be trading, you literally should be standing aside because you will lose money!

Q: Is this what patience is?

Mark: No. I wouldn't define that as patience at all. I would define that as learning. There are certain inner signals that will always indicate to you when you are in the best frame of mind to be trading and when you are not. And when you are not in that best frame of mind, then you have to be able to walk away. If you can't walk away, you're going to lose money.

Q: What kind of internal signals will tell you to walk away?

Mark: In my workshops I go through a process that actually takes people through exercises in learning how to monitor their own stream of thoughts. Think of it this way, thoughts create and direct focus. Focus is what you do. All trading errors will be preceded by thought. Learning how to monitor your thoughts will indicate to you whether or not you are on track.

Q: As you know, focus has become one of the clichés of the industry. I mean, everybody is now talking about focus and how important focus is, but nobody tells you what it is. How do you understand the concept of focus?

Mark: Your focus of attention directs your awareness. A good example of what I mean by focus is this: If a trader is focused on money and what any given trade may do for him in terms of money, then he's not focused on the market or on what the market's telling him in that moment with respect to what opportunities exist or don't exist. In other words, you could say that his thinking is distorted by his inappropriate focus, increasing the possibility of making a trading error.

Q: So thinking about the money actually distorts . . .

Mark: It can . . . I'm just using money as an example. It doesn't always have to, it depends on how the trader defines money. It depends on how that definition exists inside his mental environment. We can probably make a loose generalization, however, that in most cases, for most traders, focusing on money will be detrimental.

Q: As one trader said to me recently, "When I started taking a big loss in the S&P pit, I began converting my loss into shirts and sweaters and pairs of shoes, it really affected my ability to manage that trade." I think that's the point that you're trying to make.

Mark: This is exactly the point I'm trying to make. A trader's focus has to be on what the market is telling him in any given moment from the clearest, most objective frame of mind possible.

Q: And where does discipline come in? I mean, is discipline knowing how to control your focus? Is that the essence of what discipline is for a trader?

Mark: I look at discipline as a technique. Conventionally, most people think of discipline as a personal characteristic, as in seeing somebody else do something we can't do, but would like to. So we will typically attribute their abilities to self-discipline . . . without taking into consideration that it may not require the slightest bit of discipline for that person to express himself that way. Whatever it is he is doing, if it is effortless and without conflict, his behavior is simply a function of who he is. We need discipline when we don't have a mental structure consistent with some way we would like to behave or be.

Q: So what you're saying basically is like your concept about knowing; that when you realize that you will never know, never be certain, never be able to control the whims of the market, then you will know! And the same thing with discipline: When you realize that discipline is not necessarily a heave of the will, but it's basically doing what feels right or what feels right to your strategy . . . then you will have the discipline, but not defending against this discipline. It is not something which feels labored. It's just something that feels natural and right for you.

Mark: Well, not exactly from my point of view. It's a mental technique to refocus on the object of your goal in spite of all the internal resistance that will distract you. That's what discipline is. So in other words, if I've got a goal, it means I want to express myself in a certain way.

Q: So if my goal is to buy the market at a certain point, if that's my goal and my focus is to be able to act on my goal and not to let destructive thoughts intrude on my ability to take action . . .

Mark: I wouldn't say that.

Q: You wouldn't say that, okay. How would you say it?

Mark: As soon as you say not let destructive thoughts . . . if destructive thoughts are there, they're there. I take that back, Bob. When you say "not let," you're absolutely right.

Q: . . . I would now like to speak from my own personal experience. It took me many years to get over this phenomenon. I would take a loss, and then a second loss and then somehow I would have myself dwell on that loss to a point where it paralyzed me or prevented me from really getting involved in the market at just the critical juncture when I should have been involved. The discipline that I had to teach myself was to realize how not to allow myself to have these thoughts intrude upon my focus, that once I start dwelling on the loss, I cannot maintain the kind of focus that's necessary to get the results that would be gratifying in the long run.

Mark: So if I were to paraphrase what you just said, I would say that you were in the process of constantly redirecting your focus.

Q: Exactly.

Mark: That's the way I define discipline. Constantly redirecting your focus.

Q: Our belief system will in fact determine what we focus on, so if we believe that taking a loss is this horrible thing and all we do is think about losses and what this means to us and defend against taking losses, isn't it inevitable that we're going to take a loss?

Mark: Absolutely. Because that's what we're going to be focused on.

Q: So in essence, Mark, what is the successful strategy of the consistent trader?

Mark: Simple. Very simple.

Q: Very simple?

Mark: Yes, learning how to stay focused. Use your trading to teach you what you need to learn about yourself as opposed to trading for any other reason. In other words, what is my trading in any given moment teaching me about my state of development and what I need to learn to be better. That's the mindset!

That's what I teach traders. When they walk out of my workshops, what they know in no uncertain terms is this: If they want to create consistency, they have to approach trading from the perspective of what my trading teaches me about what I need to learn. Anything else is a distraction!

Most traders get to this mindset inadvertently through pain. I'm a perfect example of this. In 1982, I lost everything that I owned and was forced to define myself in relationship to all things that were a part of my life that no longer existed. In other words, there was a tremendous imbalance between the representation of all of the things that I used to own that still existed in my mental environment, but no longer existed in the physical environment. This imbalance was reconciled in the process of redefining myself. The point that I'm making is that by redefining myself, I saw a different market. I experienced a different market. The market didn't change. I changed. And when I changed, everything was different.

Q: Henry David Thoreau said, "Things don't change, we change."

Mark: What I do in my workshops is take people through this step-by-step process of redefining their concepts of trading so that they can create consistency, as opposed to having to do it inadvertently through pain.

Q: And the redefinition of their concept of trading from an objective definition to a subjective definition. How does that work out?

Mark: It changes in a number of different ways. Some of them I've already mentioned. It's really like learning to understand that trading is basically a game of probabilities. That it doesn't have anything to do with being right or wrong. It really doesn't have anything to do with winning or losing. These are two very fundamental and important concepts! People give lip service to these concepts, without truly having integrated them into their mental system, and what I do is take people through an educational process where that integration in fact takes place, so that they are different when they walk out.

Q: Well, of course, it's very hard for people to integrate those concepts, because if they take a loss, it's very real to them. It's real in terms of dollar amounts, so you know, it's hard for them to integrate this idea that there's really no winning or losing; there's no real success or failure.

Mark: That's the essence of the process I teach. Over the 12 years I have been doing this work, I have become extremely efficient at teaching these concepts. When people go through a 2-1/2 day workshop, they have very different ideas of what trading is all about. I teach traders how to look at their trading from the perspective of what each moment tells them about who they are and what they need to learn to do better. In a way that makes trading simple and consistently successful. That is the strategy.

Q: That is the strategy?

Mark: Yes, that is it.

Charles Faulkner

Q: Charles, what first attracted you to trading?

Charles: I was challenged by a young bond trader who wanted to move off the floor to apply NLP principles and techniques to modeling excellent traders.

Q: Could you tell me in layman's terms what NLP is all about?

Charles: Well I imagine that initially it was called NLP, neurolinguistic programming, in order to keep people away. I think it worked pretty well! Now NLP might be better called natural learning processes. What we do in NLP is look at people who are exquisitely talented at what they do.

Using the metaphor of a computer program, we endeavor to use the same programs they do. If we did, we would, of course, be much more likely to get the kind of results that they do. We know this has been true since the time we were in elementary school. A couple of students would know how to do a math problem and when they showed us how to do it, then we could do it too. This idea is equally true for more complex subjects, whether it's relationships or learning how to move up a career path or trading.

Q: As you think about what makes for a successful trader, what commonalities do you see? What are the common characteristics of successful traders?

Charles: I might get myself into trouble talking about this because it pops some balloons, but many of the people who have become very successful at this field turn out to be very bright, multitalented people. They are the kind of people who would make their mark in whatever area they went into. I'd also say that they are extremely dedicated to becoming the best at what they do. They apply themselves completely. They are not well-rounded or balanced people, at least not initially. They have decided what they are going to do with themselves and they really go for it!

Q: I'm glad you mentioned that because there is this myth going around these days that top traders are people who somehow discovered some sort of psychological nirvana and that their lives are in a pure state of balance. I've known many top traders in my career and rarely did I find one that was "balanced" in any kind of new-age sense of being totally at peace with oneself. But I want to know, what is your take on that?

Charles: I decided to specialize in working with people who are at the top of trading, and while I occasionally see a trader expressing this kind of balance, for the most part, these are very hard-working, dedicated people who experience the ongoing fluctuations of the markets and deal with them. They are like executives running a large company or race car drivers. There is the elation of what they are doing. They love it. They are doing it. They are dedicated to it. And they know there are risks and they know danger is part of the job!

Q: As you know, in this book our focus is strategy and so I want to ask you, in terms of one's overall trading strategy, what does NLP have to offer?

Charles: A lot! If you are willing to think of trading strategy somewhat differently than the conventional idea of strategy. Many people think of strategies as some kind of consciously contrived way to win on the chess board or on the battlefield or in the business arena. And while strategies certainly consist of that, NLP looks at them as a more fundamental human activity.

Our perspective is very different from that of psychology, which believes in states and forces and so forth going on inside a person. Rather we've noticed that people are drawn toward ends. People are drawn forward to their goals, to what they want in life, and they will unconsciously organize their behavior to get there. If that organization is streamlined and is appropriate to the task, then they have what we would call a "good strategy." Someone else may be pounding away and really working hard but doesn't make much headway. That's because, in essence, their strategy is not appropriate for what they are going after.

Q: So to look at trading strategy in a more specific way, what are the particular considerations in your view for a successful strategy?

Charles: Well, first what I have to say is that these are the fundamental characteristics of all successful strategies. When someone has a goal in life, whether it's to be more successful or to achieve certain results or to create certain things, he begins by going after it. And right there you begin to see his particular strategy. Sometimes, unfortunately, it is expressed as if one part of him wants to go for it and another part of him doesn't, for whatever reasons. Obviously, if this is the case, he is going to have a lot more difficulty than someone who doesn't have that conflict. He is of a divided mind.

Q: When you speak of a divided mind, do you mean he might be in a state of conflict about what his real trading goal is, what his underlying motivation for trading is?

Charles: It gets called those things. It also gets called self-sabotage, or fear of success, but all of these terms miss the mark, by a wide margin! What we've noticed in NLP is that this person has two goals, which he experiences as incompatible. For example, a trader might be very much drawn to being successful in trading, and yet he sees some of the kinds of people involved or the kinds of sacrifices that are necessary. He wonders, as he's trading, whether he is willing to make these sacrifices or not.

Well, that's a divided mind! Or let's take the example of someone who is overleveraged. He perceives an opportunity outside of his trading strategy and takes it, but knows he shouldn't be trading at this level. That also results in a divided mind.

This is not the result of some event buried in a deep psychological past. Rather it's like two goals that the person can't bring together at that moment.

Q: I guess what you are saying then is that one might experience this divided self at almost every level of trading in terms of motivation, belief, confidence . . . you name it. Someone might, as you pointed out, really want to be successful at some fundamental level but might not be of a mind or possess the ability to be successful at trading. He is not willing to go through the hoops of fire that are required of successful traders, or what Jeff Silverman calls, "Being paid to put your hand in the fire."

Charles: And that reluctance may be expressed as a desire for a more secure form of income, or as a sense of wanting to protect what he has, whether it's his finances, his emotional well-being, or his relationships with others, all of which, I might add, are positive goals in themselves.

Q: Well, personally I always zero in on motivation because I find it to be such an interesting issue for traders, and of course the strategies that they develop as a result of their motivation, their individual expression, so to speak, are most interesting. I see in seminars the full variety of motivation for trading when I go through a room full of traders and ask them why they trade. Frequently there will be two people sitting side-by-side. One says he trades because he is a risk taker and the other one says he trades for the security of it! So how does that all fit in with the issue of strategy as you've expressed it, Charles?

Charles: I think that vividly points out the variety of human beings and their motivations. It is interesting that you point in that direction because that's the first step in a strategy. If I can get technical for a moment, NLP looks at a strategy as a series of internal steps made of pictures, words, and feelings that we use to lead us to a particular outcome and take action to get there. Looking at the screen, planning our trade, shouting out a bid, or calling our broker inevitably leads to a particular outcome, which is to make the trade. Attaining a certain feeling determines our participation in the markets.

Q: I might just jump in and say that, as you know, your perspective is quite different. I find it most interesting because it is very unlike the common sense or conventional notion of strategy held among traders, where they think that a successful strategy is to learn a specific technique, a specific methodology like Elliott Wave or Gann for instance. You've seen and heard about all the keys that will never open the treasure chest and not because they aren't good! So do tell us more.

Charles: Well, if I may use the analogy of a train, which comes to me by way of Eric Oliver, a colleague; many people talk about their train of thought. You can think of each of the cars on that train as being part of your mental process. There are cars full of mental pictures, cars with the remembered voices of trusted advisors, cars full of different emotions and cars full of self-talk. There are also cars with our habits of action, whether that's jumping in too soon or hesitating until the train is about to leave. The point here is that every strategy is made up of a line of these cars, some more useful than others, yet few traders examine how they strategize. They make pictures of what they want their trades to be like or where the opportunity is, or talk to themselves and make sure they have checked all their factors. They think, "Have I got good trade position? Am I following a sound market money management strategy here?" And so on down those cars in the train till they get to the end.

Now, what is in each of those cars is the content, what most people think of as the strategy or approach the trader uses, whether it's technical analysis, neural networks, or more fundamental forms of analysis. It could also be the kind of money management technique he uses. This content is important. However, what NLP is concerned about is this: Do you have the cars in the right order? Do you have the right cars for this particular train?

Q: And are you on the right track?

Charles: Yeah. Are you on the right track? And are you on the right train?

Now this is only an analogy and we've all had the experience of being in a situation, maybe we've left the trading floor or we are thinking some trading-oriented thought, and suddenly we are faced with a totally different question, like how would we like to go out to dinner. And the next thing we know is that we are accidentally doing PE ratios on our favorite restaurants. Or risk/reward calculations. It's just our brains sliding over from one time period to another. This also goes the other way. We're using the same mental strategy to order breakfast as to put in our bond order. So the kind of strategy that we bring to trading is of vital importance. It's necessary to take the time to examine your train of thought. To find out, do you have the cars that you need on it? There are different thoughts, ideas, resources, and mental and emotional skills that are needed on that train. And are they on the right track? That is where we at NLP have something substantially different and important to offer to strategic thinking as it relates to trading and everything else.

Q: The NLP train sounds a lot different from the Chattanooga Choo Choo; I mean this is a train of indeterminate dimensions.

Charles: Well, going back to your point about motivation, the first step in a strategy is this: Is the person looking more for trading opportunities or avoiding risk? It seems like a very simple dichotomy, but if you were to go back to those people that you spoke of in your seminar, and drew a line between them, you would begin to notice that some people seek security and others excitement. The first are moving away from risk. They want to keep things calm and under control. On the other side are the people who want a challenge, want to win the game, and want the stimulation of the play. NLP describes these as the two sides of motivation direction: Moving *away from* unpleasant or painful experiences and moving *toward* pleasant and pleasurable experiences.

This dichotomy allows you to win on either side. There are big players on both sides! In fact, my own research indicates if you haven't taken care of the downside by taking care of security and managing risk and avoiding danger, that in fact it will come back to bite you. Really good traders have this aspect built into their strategies. Everyone is naturally more responsive to one side of motivation direction than the other. This, of course, biases the kinds of opportunities a trader will look for. It even biases the kinds of trading approach or trading system that he will be drawn to.

Q: Let's talk about that for a second. How does strategy in your view relate to the selection or development of a particular trading system?

Charles: You have to have a systematic approach to the markets, which is going to allow you to take a return that other people don't have. This can be, as we know, arbitrage, hedging futures or any number of different approaches.

Q: Scalping, day trading, spreading, or options.

Charles: It's amazing. Our ability to create these different approaches is almost endless.

Q: It's what I call the 360-degree universe of opportunity. You can go any way as long as it's effective and consistent over time and the way you know is very simple. . . . It works!

Charles: Well, this is why I say it is crucial to understand the word strategy in a bigger sense than the next trading system. Technique will tend to be overvalued by someone who didn't understand that. That's why some traders are drawn to an approach that promises them 85 percent accuracy in calling the markets. Other traders are drawn to an approach that has a limited amount of draw down. Both are risk avoidance, *moving away* from motivation strategies. Yet other traders are drawn to something that will allow them to be a risk-taker. They are unconsciously drawn toward a certain trading approach. So you see, each trader ultimately chooses an approach based on either being drawn more towards excitement and stimulation or more drawn away from excitement to a calming influence, a desire to keep things on an even keel.

Q: Charles, would you agree with me when I say the market is like a giant Rorschach test? In my opinion every aspect of the market becomes an expression of this sort of inkblot interpretation. As you put it, your motivation, whether it's moving away or going towards, in fact, every aspect of trading—from your analysis of the trade to the particular technique that you employ—is ultimately your own interpretation of the inkblot, isn't it? What Bandler and Grinder used to refer to as a hallucination of reality?

Charles: Well, given the negative value associated with the word hallucination, we prefer the word bias or leaning. And yes, we know that people look at their computer screens or hear those numbers shouted out and they mean very different things to each person.

Q: Well, let's talk about strategy and how it relates to the whole trading process from your point of view, beginning with the selection of the trade to the analysis of the market, or in fact, even the selection of a particular market. How does strategy from your point of view play itself out?

Charles: I take a rather analytic view of this. There are three kinds of strategies that come into play when anyone wants to do something. They are motivation, decision-making, and conviction. Motivation will come into play primarily either in a defensive or an offensive way: away from loss or toward profit.

Once that's happened, the person will select a market that has the towards or away-from emotional bias that he finds familiar. The feeling that they have been down this track before. Then the actual decision strategy comes into play. Now the question is, how do I get into this market? And at what level of commitment? Do I wait for a certain number? Am I looking for a certain movement? At this point, the person's decision-making strategy needs to be automatic.

We all hear about traders who second guess themselves. Once you second guess yourself, it's over. Another way of saying this is: The mental steps need to be in place and honed and stream-lined enough that you will automatically follow your approach with consistency and conviction. Pete Steidlmayer pointed out years ago that the markets are really easy in a way, they either go up or down. All a trader needs to do is adhere to his approach and if it doesn't make money, reverse it. If you can't be consistent or you experience an inner conflict, then there's a glitch in your strategy, and it's holding you back.

Q: I think it was Baruch who said the only thing you can count on the market to do is fluctuate!

Charles: I agree with that. The issue is what happens when a trader has a glitch at the point he is drawn towards two or more goals? That in itself isn't a problem; in fact, it's a fact of life. The market fluctuates, and so does our attention. Sometimes we would like to eat, but we have to stay and finish our trading. But when these conflicts get strong, then they can freeze up or literally paralyze the strategy.

Q: What happens when these glitches get stronger and become more contradictory? When the motivation of the trader to become successful is in violent opposition to his ability to initiate a trade, what traders refer to as pulling the trigger?

Charles: So strong is his motivation that he has got his trading software, his Tradestation, and data feed, and he has studied the markets for years, yet he hasn't completed one trade. He is motivated and in conflict. The difficulty is with his decision strategy, not his motivation.

Q: His other goal is not to lose money. Or maybe it's to be perfect.

Charles: Or not to be wrong.

Q: Okay, so what do you do in a situation like that? When somebody comes to you and they do have these opposing goals and you know they are fighting each other?

Charles: I look at it as the by-product of not having considered everything upfront. For example, a trader looks at a market opportunity and thinks, "Oh, it looks good here," and his train of thought begins moving. Then further down the track a voice comes in to contradict or review: "You know you got killed here the last time you tried this!" And at that point the two thoughts or goals are in opposition. The first goal is to take advantage of a market opportunity, the second to minimize risk. Both are very important skills for a trader. The question is how they are applied.

Q: So is that an ill-developed strategy from your point of view? That either the person hasn't developed a contingency plan or hasn't considered a natural outcome of a market at this particular stage of the trading process? Or maybe he hasn't even tapped into his own personal reaction to that eventuality.

Charles: Yeah, exactly. The crucial point here is that the train, the strategy, is unconscious. So they haven't previously thought that they might be getting themselves into trouble. In fact, what usually happens at this point is the person will go into intense self-examination, feel even worse, and look at his screen again.

What traders often see is they really lost the opportunity in that market because now the market is moving like crazy in the direction they thought it would initially. So, of course, they have to feel even worse. It's not really any different than going into a clothing store and seeing a jacket or something and thinking, "Hey, that's pretty nice." You like it, and then you flip the price tag over and you think, "They're out of their minds!" When you have that second reaction, you leave the store and you don't have another thought about it. But if that price is just a little too high, you start negotiating with yourself. "I like it. It's really nice and so on." It's a simple example, and buyer's remorse is another simple example of this. You buy something and later on you wonder, "What was I thinking!" It's like a car in the train of thought that comes by later.

Q: So are you saying then, when someone has that inability to act at a decisive moment in time, when he can't pull the trigger when he should be automatic, that it is a form of buyer's remorse?

Charles: Buyer's remorse is the same kind of inner conflict. What needs to be done, rather than more self-examination, meditation, or steeling oneself to one's fears and failures, is to think of your brain as a kind of computer that you just didn't load the information into properly. What I'll do with traders is guide them to consider the upside and the downside before going into the trade. It's simply a matter of getting the cars lined up properly. After all, when you go into the store and you've decided not to spend more than $600 on a sports coat, then you can look at the coats at that price, and then you're done with it.

Q: So for the person who gets paralyzed at the moment of decision in the market, basically what you do for him is get him to see that if he wants a trade he has to calculate the necessary risks and rewards.

Charles: I would say, see, hear, *and experience* it so that it becomes a new automatic unconscious strategy.

Q: And you do that as a mental rehearsal.

Charles: Yeah. With NLP you can do that as a mental rehearsal and you do it in a story form.

Q: How do you do that?

Charles: Well, I was just doing that with you when I told you the story about someone who would go in and buy a jacket or order a meal. Remember it's an unconscious strategy and not a conscious one. Willpower is not the issue here. People who get into trading have got the willpower to do it. When they spend this kind of time and energy, effort and money, going after something with these kinds of risks, you know the willpower is there.

Q: The idea of reworking the unconscious process seems to me to be problematic. I mean, do you make an attempt to understand what the current unconscious process is or do you make the assumption that there is an unconscious process and deal with it at that point? What comes to my mind is the trader who can't get into a market, who can't pull the trigger. In some sense you never know what that fear represents. And it could represent anything! It might be some kind of unconscious response to something that occurred to the trader in childhood. Is it important to know what the unconscious motivation or value is to that individual from your point of view, Charles?

Charles: I think my answer is going to demonstrate how far NLP has moved away from psychology. Psychology would say it is very important to understand the past, the deep motivations, even the collective unconscious. And that may be useful. However, from the NLP point of view, it is more significant that we have the means to change the strategy of what we pay attention to, how we decide, and what motivates us. It's how it is, more than what it is, that's causing the difficulties. It's like jumping in your car and tooling down the road and then turning the ignition key. The sequence makes a tremendous difference. It doesn't matter how much you know or how much you want to get to your destination! Or even what will happen if you don't. Or what deep childhood history motivated you to want to get there, if you don't put the key in the ignition.

Neuro-linguistic programming refers to the analogy that the brain is a kind of computer. No one asks what the motivation of a spreadsheet or word processor is, but rather, is it functional? Will it interface well with the other programs? Neutralize the paralyzing fear, increase the toward motivation, streamline the decision strategy and make sure the convincer evidence for an opportunity has been reliably backtested.

Q: To use your analogy, ultimately it is the strategy that is the key isn't it? I mean if one wants to be an effective trader, the strategy is the key which turns on one's beliefs and actions and motivations and . . .

Charles: It's interesting that you mention that because it was a debate inside NLP many years ago. The question was, which is more important, the mental state of the person, that is, their emotional state of excellence, or their strategy? At that time, John Grinder, one of the co-founders of NLP, and Robert Dilts, an early collaborator, decided to take opposite positions. Not surprisingly, John Grinder took the position that the state of someone was the fundamental basis on which you could achieve excellence. After all, if you are in a good state, if you are feeling powerful and resourceful, your thinking is going to be clear and focused. You will have access to all the mental strategies that are needed on the occasion. Robert Dilts took the other side in this debate. He pointed out that to get to a state of emotional resourcefulness, of confidence, of tenacity, is in itself the product of a successful strategy.

Q: What's the answer?

Charles: The story demonstrates that both are necessary as well as their interaction with each other. A trader needs a strategy to get to states of excellence, confidence, and competence, to throw off the last bad trade and get right back in to what he is doing. And that same trader needs the positive emotional states and a variety of other states to deal with different trading situations effectively.

Q: You said a moment ago that a trader needs several kinds of strategies to get him there. What do you see as the essential elements of a trading strategy, and how can a trader look critically at his own strategy?

Charles: First, the same strategy that you use to choose lunch or that you use to decide what shirt to wear in the morning or even whether to pick up this book now is the same strategy that you use to select your life partner, where you live, and how you trade.

Q: Now this sounds very interesting to me however I don't quite understand what you mean. Would you elaborate?

Charles: If you think about a word processing program in a computer, it doesn't matter whether you are writing a memo or a 300-page book, you're using the same program. The brain functions the same way. It doesn't matter whether you are making a small, everyday decision, or whether you are deciding to pick up a hundred contracts in the bond market. The point is you are using fundamentally the same mental strategies. Some people find this idea really appalling when they consider that they are doing it this way. But in fact, it is a pot of gold because it means in all the little moments of your life you can discover how you make decisions, how you motivate yourself and how you become convinced of value. If you find glitches or difficulties or omissions in them, then you can change these strategies and have it not only change your everyday decisions but also those important trading decisions as well, automatically.

Q: Well how do you do it? You trade, Charles. How do you do it in terms of your own strategy?

Charles: First I need to give you the list of the characteristics of successful strategies. In any strategy of any size, these characteristics are always present. First, as I've said before, it's automatic. Second, it is congruent, it isn't of a divided mind. It's all going in the same direction. Third, which isn't essential in most of life but is absolutely essential for a trader, it includes moving away from risk as well as moving toward reward.

When people make effective decisions, whether it is buying something or being in a relationship or trading, all of these characteristics work better if you imagine already having done them in advance. That is, if you go to buy something for yourself or your account, does it fit into your overall plan, and the life that you've got. Does this trade fit into your portfolio? Or another way of asking the question: Does this trade fit into my overall trading strategy?

Q: Is this conscious or unconscious?

Charles: It needs to ultimately be unconscious and automatic. The trader already does it for small decisions and he's learning to do it for large ones. Finally, and more importantly for trading than in other parts of life, the trader needs to have evidence, well-developed evidence, about when to get out of a trading situation.

Q: When you're wrong.

Charles: Exactly.

Q: So how does that play out in a real trade? For example, for the person who wants to day trade bonds, we can understand the automatic and congruent part of it. It has to feel good and he has to have the motivation. The evidence would be based on experience or on something like pattern recognition, but not limited to that kind of tactic: is this the right thing to be in? But I'm not sure from your perspective how this idea of "Is it right for me" applies in a real way to the trader?

Charles: Okay, let's look at a situation where a trader's looking at the bonds and sees an opportunity relative to his approach. The first step is to want the trade or not. Is there some sort of a threshold of opportunity? If it doesn't look that good, instead you might watch it, but not initiate the trade.

Q: It could be indecisiveness.

Charles: Yeah, but here it's watchfulness as opposed to indecisiveness. For whatever reasons, it's not a good enough opportunity yet. Those are the automatic and the congruent parts. The next step is when the opportunity does emerge for this person.

Q: And by the way, this is occurring in milliseconds.

Charles: As an example, I modeled Pete Steidlmayer, whom I got a chance to see up close as well as listen to on audiotapes. I analyzed his language patterns, and so forth. Pete has a six-stage strategy with 122 decision factors that we were able to isolate, that he runs in 50 seconds or less. Many of them are automatic. They are just checked off. He's been through them so many times that it's like, "Yes and the breakout is large enough and the profile movement is fast enough. . . ."

Q: By the way, for many people these kinds of decisions wouldn't even come into consciousness. It would be intuitive.

Charles: If it comes into consciousness, if the person is conscious of each step, it's like trying to walk consciously. Or to make another analogy, it's like first learning to drive a car. You had to keep track of the pedals and the steering wheel, and you may be far enough back that you had to shift this stick around and move some pedals while you were driving and listening to someone next to you nervously barking out instructions and see where you were going too! Most of us don't want driving to be that conscious any more. And it's the same way with trading. If the trader is consciously thinking of each of these steps along the way, he is in real trouble. In fact that usually happens most when the strategy isn't working. A rule of thumb about strategies is the more effective the strategy is, the more unconscious it is.

Let me offer you an example that just about everybody is going to be able to relate to. When he was doing his mutual fund show on CNBC, Jimmy Rogers would always ask people, "Should I buy some now? What should I own?" He was running that step of the strategy, stepping into the trade and going through the process of "what if I already owned it?" Tom Baldwin said very much the same thing at the 1994 FIA conference when he said, "There is your life before the trade and then there is life after it." The effective trader is someone who will check out as much as he can in his imagination, which isn't all that much, but it's an edge. He'll check it out and ask, "Do I want to actually be in this trade? Does it look and feel good having the trade on now?"

One last thing about the evidence is that we can slide between our decision strategy and our convincer strategy and get what is called second guessing. Whether it's a number, a price, or a percentage, a trader needs to know when to scratch a trade. My own trading rule is if you don't know what is going on, get out. I have always found that to be a useful rule. Part of its usefulness, I might add, is simply because it is a rule.

Q: One of the first axioms of trading is, when in doubt stay out.

Charles: And yet how many people follow that! They begin to run another strategy in which they begin to second guess themselves and offer reasons why this market is going to recover and so forth.

Now at this point it might be technical, but also very useful to point out that our brains have a part, an actual physical, locateable part, whose job it is to develop reasons why we did something. The research was done by Dr. Michael Gazzaniga, one of the original people who discovered that there were separate brain hemisphere skills: left brain work and right brain work. His research has been corroborated by Dr. Martin Seligman who has written a wonderful book called *Learned Optimism* (New York: Random, 1990). The idea is that how we talk to ourselves is a kind of belief and a very important way that we build confidence in ourselves and our world views. Once again, it's an unconscious process until we notice it, and it so powerfully shapes beliefs that most traders, at some point or another, will want to learn to relate to this part of themselves in a way that's useful to their trading.

Q: Seligman's work is quite interesting and I talk about it on occasion in my seminars. In addition, the concept of true competence as I teach it is the psychological exchange of skills from a conscious to an unconscious level of awareness . . .

Charles: Yes, that's Larry Wilson's theory of how the mind works. That's certainly one approach and there are others that work as well, but what's most essential is the trader notices that this happens after the trade. Let me explain how this gets expressed. A trader will get into a trade for one reason. He'll notice an opportunity in the market according to his approach. This often happens with day trading. Once he is in the trade, the market will begin to move in an unexpected way and "when in doubt get out" just doesn't come into play. Instead the trader begins to look at it as a different trade. And the decisions that brought him into the initial trade are scratched in favor of doing the trade for another reason. The trader at that point is treading on incredibly thin ice.

Q: Well, years ago when I still pit traded, I used to say to my clerk the name of a day trade that doesn't work is "position trade."

Charles: That's truer than most people want to believe. Because they suddenly think, "Hey, it wasn't a good day trade but it looks like a good position trade now." If the trader can keep track of his own mental revisions, it might work out. But the real danger is that the evidence—the last thing I talked about in the strategy—the evidence that was being applied in the first case has now changed. And the trader has just practiced ignoring his own procedure for getting out. If say, the market changes again, the next morning, and now the trader decides, "I am going to keep it" for yet another reason, then once again the evidence changes, and once again the trader has practiced not following his own trading strategy. You can see that in no time at all he's building a habit that does not serve him.

Q: So, Charles, you have spoken about the different elements of a successful trading strategy. But where does state come into it? What is the relationship between strategy and state?

Charles: I agree with John Grinder that you can get to your resources more easily when you are in a positive state than when you are in a poor or less resourceful one. But I also take the position that you ought to be able to get to your trading strategy no matter what state you are in. Too many traders allow their strategy and their ability to trade to be dictated by their emotional states. To give myself as an example, when I was doing my early research and study I came across the remark in Richard Dennis' work that the only way to make money in this business was to keep an overnight position. So I just found a market I liked, took an overnight position and dealt with it. At first I had all the same emotional upheavals that any inexperienced trader has but then I applied my NLP skills to be calm and focused about the trade.

Q: How did the trade work out?

Charles: I lost money.

Q: But you had a good state.

Charles: Which came in very handy later on when the markets began to move against me with much larger positions.

Q: You see, Charles, from my perspective, having traded for many years on the floor and having had to manage very large trading positions, it occurred to me that state actually dictates strategy. You know, for good or bad. And so maybe we are kind of reenacting the debate between Grinder and Dilts. However, it seems to me that state will in fact determine which strategy will be employed by the trader every time.

Charles: I agree, and in fact I have been in sessions with people who hire fund managers who say that although they know it's illegal to ask traders about their intimate relationships, if they're not good, they don't buy the fund. Emotional states, especially during upheavals like divorce and even getting married, can be so strong that they throw off a trader's natural ability to get to the skills that are necessary in this business. There is no question about this.

This may be a by-product of the kind of people who are drawn to trading. In NLP, we talk about people having a more prominent development in one sensory system than another; some are oriented more visually, others are more oriented to the auditory mode.

Q: How does that relate to trading?

Charles: Some traders are naturally disposed toward emotions and action and physicalness, what NLP calls kinesthetic. I would agree that floor traders lean very much towards the kinesthetic. They are very action-oriented. They are emotional creatures. And given that leaning, their emotional states are going to be much more crucial to their trading. However, I think that it creates a disadvantage for them, in that, if some other trader can upset them, or if the markets move rapidly and they don't have the strategy skills to shift their emotional states when they want to, in a moment that adrenalin, their feelings in those situations, places them at a disadvantage to the trader who can.

Q: But I would suggest, Charles, that even if you were a long-term trader, I know in terms of my own experience that I traded as much off the floor as I did on the floor. That state of mind is a critical factor, as a way of testing your judgment and the way you feel, not only about the market, but about yourself.

Charles: State of mind is certainly important. However, an additional question is how attached is that trader's state of mind to the numbers on the screen or the particular trade he is in that day? Or the quarterly performance? The more the trader has the ability to direct his own emotional states independent of those factors, to decide when he is going to feel confident and resourceful regardless of what the market is doing, the more access he will have to all his strategies and the more of an edge he will have.

Q: Where does consistency fit in all this, in your opinion?

Charles: It is interesting that you would ask that question because the middle term in neuro-linguistic programming is about language. At one point, I got interested in the definitions of different words used by both young, inexperienced, but hopeful traders and by actual supertraders. They would both use the same words, but they used them with very different meanings in mind. In the young, inexperienced trader, consistency was first and most often related to being right. If they weren't right a lot, they began to be wrong about this and wrong about that. It would just destroy their state. It showed the attachment between the markets and their emotional states. With the experienced trader, being right was practically irrelevant. The supertrader, if you will, was much more concerned about the probabilities of the situation.

The next level of consistency that the young trader would graduate to would be consistency in terms of earnings. Making a little money here and a little money there would become evidence of good trading and getting better. Whereas for the experienced trader, consistency related to market approach. The consistency was making money, of course, but more important was their ability to use the evidence and adapt their trading based on the evidence for that trade, and so on.

Q: Meaning using the evidence to think more in terms of probabilities than in terms of being right or wrong.

Charles: Yes.

Q: What other considerations of trading strategy do you think the top traders you have known and worked with are concerned about? You mentioned, thinking in terms of probabilities and maintaining a consistent methodology. What are some other issues that come up for the supertraders?

Charles: This goes in two directions. Once again, there's the unconscious strategy and then there's the conscious effort. Although they might not think about it in this way, to come back to Martin Seligman's work, the consistently successful and seasoned professionals in this business have either on purpose or by accident adopted a way of thinking about themselves and the markets that allows them to come back every day, and trade actively, whether they lost the day before or not. They may have been losing for a quarter or they may have been on top for months, what is key is that they have a mind set, a set of beliefs, that orients them to the long-term process as opposed to the individual results.

Q: So the successful strategy ultimately is to stay in the game over time and think of it in terms of an ongoing process rather than a series of independent trades.

Charles: I'd say both. A series of independent trades that are parts of a larger process. Each trade is important. But each trade is only one trade. And success is measured by what you are reading out of your samples over time.

Q: Right, and is only one piece of evidence within a large body of information. . . . And in terms of developing evidence, your consistency is being true to what you're reading out of your samples. . . .

Charles: This idea of success also gets expressed consciously, as the traders continue to improve themselves. It literally becomes an unstoppable desire. When I step into various traders' offices, I see them reading books on game theory, or teaching themselves new forms of market analysis, or trying out new software. There is this relentless pursuit of excellence that they continue to express knowing that their edge is only going to last so long. They need to continue to find another one. As much as they would love to have a money machine, they know that, just like everything else, their approach has a certain obsolescence to it.

Q: I know you and I have spoken about it before, Charles; could you also talk a little bit about the concept of having fun at trading?

Charles: I have this five-point checklist to identify someone who is oriented toward becoming a successful trader. Then Ed Seykota offered me the short version, "Look in the mirror and say to yourself, 'I am a trader.' Do you believe it?" Here is the other questions to ask: is trading suited to your lifestyle? Is it something you really enjoy? As Tom Baldwin says, "Everybody would like to have the money but who is willing to do the work?" And the work is tremendous! It is a huge commitment that you'd only want to do if you loved it. Do you delight in thinking about how the market works, or would you really enjoy playing the game even if you lost because you got to play? You have to have the feeling that you have to be in the big game. It's that kind of underlying desire that I think carries people through.

Q: What are the other points on the checklist?

Charles: As I mentioned in my interview with Jack Schwager, you need an edge and you need the mental and emotional flexibility, including not only how you look at the markets but how you think internally. Also, what kind of beliefs do you have about yourself and your ability? After it's over, how do you look at your accomplishments? And finally, the operating metaphor is the mindset of the trader, which organizes those beliefs and values into a complete persona that he brings to the markets.

Q: In terms of specific tactics in one's overall trading strategy, both mental and methodological, in your opinion, why do traders constantly reject the simple ones that work for the more complicated ones that don't?

Charles: What you have noticed anecdotally is supported by evidence. Psychologists have done extensive studies on this and found that human beings, given a choice between a large, complex, intricate, and baroque system that doesn't work and a simple one that does, will choose the complex one. It has something to do with the idea that if you can't understand it, it must be profound and important, and you shouldn't question it.

Q: Does that account for why 10 percent of futures traders are successful. Is that one of the reasons?

Charles: I wouldn't want to attribute it to one factor but I'll bet it contributes a lot. Ed Seykota among others has mentioned that he takes incredible sums of money for making very, very simple decisions. When one of the "turtles" revealed how Richard Dennis really traded, the Donchien Channel Breakout, students of this guy were astonished. They were asking, "That's it? That's how this guy made $200 million?" And the answer was "Yeah."

Q: Can it be that simple, Charles? I always say at my seminars that the funny thing about market axioms is that they are all true. However, people can't use them! The truth of the matter is that they're simple, but unfortunately not easy.

Charles: This is where I think NLP has made an important contribution not only in trading but across our culture. People are beginning to realize that there is a vast difference between understanding and performance. I think it is finally beginning to sink in!

It doesn't matter how many trading books you have read or how much you've studied something. The ability to trade, the ability to perform in a sport or speak a foreign language or drive a car is a matter of practice, experience, and knowledge. Making it more complicated does not make it better.

You learn to ski by skiing. You learn to trade by trading. The analogy is particularly useful when you recall learning to ski; you started on small hills and maybe even special skis. You built up a foundation of ski experience that paved the way for blue and black diamond runs. The inexperienced trader can learn a lot about trading and risk management by trading anything or by small-stakes gambling. In fact, many of today's great traders got their starts in just this way.

Contrary to what the educational process in this country has tried to get us to believe, you don't learn to live your life. You live your life and you learn.

PART III
THE TOP TRADERS

Chapter Six

Patrick H. Arbor

Patrick H. Arbor is an independent trader and principal in the trading firm of Shatkin, Arbor, Karlov & Co. He was elected chairman of the board of directors of the Chicago Board of Trade in 1993. Mr. Arbor served a three-year term on the CBOT's board of directors from 1990 to 1993, after serving as vice chairman from 1987 to 1989, and as a director from 1985 to 1986, and from 1980 to 1983. He is also chairman of the board of directors of the MidAmerica Commodity Exchange, an affiliate of the CBOT, and previously served as MidAm Exchange and Executive Committee vice chairman. Mr. Arbor has been a member of the CBOT since 1965.

A native of Chicago, Pat Arbor received his bachelor's degree in finance from Loyola University in 1958 and did graduate work at the University of Chicago. He started his career as a math teacher and later served as mayor of Harwood Heights, Illinois. Currently, he is a director of the First State Bank and Trust Company of Park Ridge, a $325 million bank holding company, and a member of the board of regents for the Mercy Home for Boys and Girls. He also holds memberships at the Chicago Board Options Exchange and the MidAmerica Commodity Exchange.

Q: Pat, what first got you interested in trading?

Pat: I was attracted to the challenge the markets presented. From the time I was a little kid I was always good with numbers. In fact, I was usually elected class treasurer, never president! I also liked matching my wits against others. When I was younger, I would think nothing of going home and picking up one of the Mensa books and trying to figure out a brain teaser. So for all these reasons the markets were attractive to me, because they presented that kind of a challenge.

Q: What still excites you about trading today? What do you find most enjoyable?

Pat: The winning is incredibly exciting! To know at the end of the day that you've made the right decisions. My trading has always been based on arbitrage or spreading. I never concentrated on figuring out the direction of the market. I was always very good at spreading one month against another, whether it was the soybeans, corn, or bonds.

It became quickly apparent to me when I first came on the floor of the Chicago Board of Trade that the money was made by the spreaders on the Exchange. That is the consistent, steady money. Spreading was well-suited to my general approach because, as I said before, I liked mathematics. I like to add and subtract and figure out probability. And spreading, of course, is nothing more than just that; to be able to quickly figure out the differential between one month and another and then skillfully execute the trade.

So, for example, when I was trading soybeans and I would see that the Cargill broker or the Central Soya broker wanted to buy May beans two cents under July and there were millions of bushels to do there, it didn't take me very long to figure out if they wanted to do it, then I wanted to do it. And I would make it a point to do it better than that broker because I would concentrate my total focus and efforts and I would amass a position. When all else failed, I reasoned, the worst thing I could do would be to scratch the trade with him. Many times I would catch the market out-of-line and capture the differential, and that's really the function of a spreader or an arbitrager, to be able to catch a market that is out of line and to execute the trades. Typically, the market quickly aligns itself because collectively spreaders act as a competitive force to bring the markets back into line. Even the Cargill broker that I mentioned earlier might do the same thing. So as I was saying, it was really spreading that allowed me to achieve whatever fortune I've made here.

Q: What would you say is your greatest strength as a trader?

Pat: Discipline. Discipline. One word . . . discipline. It is the discipline, believe it or not, of knowing when to trade and when not to trade. Clearly, there are times when you shouldn't trade. If the market is particularly slow and particularly dull, don't trade.

Q: And that applies, I would assume, equally as well to people who are off the floor . . .

Pat: Many times, I see people on the floor, because it's a natural tendency, making markets when they shouldn't be, where there is literally nothing more than cannon fodder for the professional floor trader.

The second discipline I want to talk about is the discipline of taking your loss. There's two things you're fighting when you have a loss. Number one is the money that is coming out of your pocket and of course you don't like that very well. The second thing is your ego . . . that if you liked it at the earlier price, and now it's cheaper, you should like it twice as much. You must have the discipline of being able to take a loss and eliminate the ego so that you're able to keep trading.

You take a loss and you turn around and you do something else. Maybe you reverse yourself. Maybe you buy back higher. Who knows? If you're wrong all you have to do is sell it out lower. See, for most people, it seems that's one of the most difficult aspects of trading, that they either dwell on the loss or they allow it to incapacitate them. So the discipline is having the ability in the face of that loss to keep on trading.

I would have to say that personally I take an awful lot of losses! If there's been a secret to my success, it's taking losses. You see, although many of my trades are losers, I know how to manage the ones that are good. I know how to milk them into more than the losses. One should never be afraid to take a loss. As a matter of fact, I often remember the story of Everett Clip, who's one of the senior members of the Exchange. He has a trading company called Alpha, and he does a very interesting exercise with the new traders he brings onto the floor. I always tell this story because it really gets to what trading is all about. Everett will take a new trader and march him right down to the middle of the bond pit, and he'll say, "Now, watch this." And he'd say, "What's the market?" "Five bid at six sellers," someone says. Everett would say to the new trader, "Watch very closely." He then turns to the guy who gave him the market, "I'll sell you one at five and I'll buy one from you at six," Then he turns back to the young trader and says, "You see what I just did?" The young trader would kind of look, his eyes wide open and say, "Yeah, you just lost a tick." Everett then says triumphantly, "That's right. Never forget it!"

You see, that's how you take a loss, dispassionately, no emotion. If you can learn that, you'll be a successful trader. It's very, very important that you know how to take your losses and come right back. You must always operate under the principle that you want to be here for the next trade. If you can do that, you will never jeopardize your whole career, you'll be absolutely fine.

Then, of course, there's the whole issue of discipline as it relates to your financial ability. If you have a small account, you trade small. If you have a large one you can trade bigger. But controlling your trading size is another discipline that's critical.

Q: What about the ability to execute? You hear so many traders complain about being gun-shy, being afraid to pull the trigger. How do you respond to that?

Pat: Well, in my career I've seen people handle that issue in different ways. All I can tell you is that the more direct you are, the more head-on you are about it, the better. I remember one trader, a friend of mine, who had trouble doing that. He went to see a psychiatrist. He would come into the pit, buy or sell something and then reverse himself and would immediately take a loss. It was apparent to everyone in the pit that the way he was taking the loss and reversing himself was an indication that he was getting some kind of therapy to be able to demonstrate to the world that he could take a loss. Now I'm not suggesting that people have to seek therapy for this.

I used to know another fellow who was always so embarrassed about making trades that he would come over to me and ask me to get him out of his bad trades. I can remember that happening a couple of times. I think that the best way to do it is to be able to say to yourself that Babe Ruth struck out over 3,000 times and went on to become the home run champ of the world. So you've just gotta keep plugging away and assume you're gonna hit the ball.

I can't emphasize this point enough. Losses should not dissuade you from making trades. I mean, you should not have a fear of them. For many pit traders it's the embarrassment, you know, it's the loss of the money in front of others that freezes you. And also the ego, the fact that you could have been stupid about something. I'm stupid all the time about trades, and I lose every day in the market. Every day when I trade, I lose! Fortunately, I have more winners than losers.

Now, as far as trading off the floor, I try to gear my trading strategy to suit off-the-floor conditions as much as I did when I was on the floor. I cannot be on the floor by virtue of my position as chairman of the Board of Trade, so what I try to do is a form of spreading that will work from upstairs. For instance, if I'm long wheat as I am right now, I am short some fall options against it or I'm long some put options against it. If I am long wheat, I may be short corn against it. Or if I'm long beans, I may have options against it or some other corn position against it. I always try to have some type of protection in the event of a calamity. I also try to buy strength and sell weakness. If I see that one is particularly strong against another, I'll try to buy the strong one and have some kind of hedge against it. Now, remember we're not talking about apples and apples here. We're talking about apples and oranges, but even fruit sometimes moves the same way in price. I think it's very important to trade that way. You see the way I plan my trades is I approach trading in a way where I never try to hit home runs. I'm not a good home run hitter, but I'm damn good at hitting singles!

I remember trying to explain this to someone in Italian, because I have this great affinity for the Italian language and I've studied Italian, and I'd say the Italian word for bean which is *fagioli.* I said it's like trying to put one bean in a bag every day. At the end of the month you're gonna have a lot of beans and at the end of the year you'll have even more. Many traders try to put all of the beans in the bag in one day. Isn't it better to take a disciplined approach, a moderate approach?

I would counsel young traders at Shatkin, which was the largest clearinghouse in the world at the time. We cleared more trades, had more customers, more local floor traders. . . . At one time we had five or six hundred floor traders. I can remember taking a young trader aside years ago and asking him how much he was making. He answered 15 or 20 thousand a year. Maybe somebody would be making a little more, but never more than 40 or 50 thousand. And I'd say, if you make $100 a day here, you're making $25,000 a year. It's a simple mathematical calculation to do that. And if you make $500 a day, you make $125,000 a year. And if you make $1,000 a day, which doesn't sound too difficult to do, and it really isn't, you are making a quarter of a million dollars, $250,000 a year . . . that's $50,000 more than the President of the United States makes! It's more money than your father ever made in his life, and his brothers and so forth. And if you do that, you know, for a number of years, you're going to be able to save "X" amount of dollars, and pretty soon, you'll have a $100,000 CD in the bank, and that first one will be tough. But the second $100,000 CD will come easier, and then you can graduate up maybe to making $4,000 a day, and at that point you're making a $1 million a year, and after you pay your taxes and expenses you probably can save, you know, a couple hundred thousand dollars a year and before long, you'll have $1 million CD.

Q: That's a lot of *fagioli.*

Pat: Yes, it's a lot of *fagioli.* A lot of beans, and that's the approach to take, I think. In my experience, it's been those traders who are quiet and grind it out everyday consistently who are the most successful traders.

Speaking of consistency, we seem to attract a lot of tennis players and they seem to do quite well as a group.

I could mention half a dozen to you right off the bat. Maybe tennis players recruit other tennis players and so we have quite a number of them on our exchange. As a group they seem to have a great drive to succeed. Of course, you have to be motivated to be successful. Hungry is important! But in and of itself hungry is not enough. You can't have that alone, because you have to have all the other things, too. I've seen people who are hungry who can't make a dime. They want it desperately but they have no strategy, no game plan.

Q: It's not enough to have appetite. You have to have the menu.

Pat: Yes. You need an appetite and a menu. And a fork and all the other things!

Q: Pat, when you first started trading what were your goals?

Pat: Very modest. I can remember after graduating from college, I thought that if I had a $10,000 a year in income, I'd be set for life, and if could ever get $100,000 in the bank, well. . . .

Q: I don't just mean monetarily. Did you have an overall trading goal?

Pat: I grew into it. When I first came to the Board of Trade, I didn't know anyone. I came down here pretty raw. I did not know what I was doing. I lost money in the beginning. My first trade, I think I bought 5,000 bushels of soybeans and watched it go down 30 or 40 cents, which was a lot! I mean, that was a lot of money to lose, a couple of thousand dollars. Then I gravitated to filling orders and I was a broker for a long while. I filled orders in the corn market and in the beans.

I will tell you that I did fail. I left the Board of Trade in 1968 and I didn't come back until August of 1970.

Q: I can't tell you how many people who we've interviewed had a similar experience. Leo Melamed, Jack Sandner, Bruce Johnson, Tony Saliba, Don Sliter. The interesting thing is all of these traders possess this incredible resilience to come back. And I'd like to hear more about that. What do you think that is all about?

Pat: Well, I think you're right. I think it's a great character builder to go through an experience like that. It's not a very nice experience, because you've lost most, if not all, of your assets, and of course it's very disturbing to your whole life, your business life, your commercial life, your family life, your social life, but it lets you learn something about yourself that is hard to learn in almost any other way.

Q: I often wonder about that because I've been through that kind of experience myself. Do you think it is essential to experience that kind of a personal meltdown?

Pat: I don't think so. I think that for our generation of traders, as you mentioned, for Leo and Jack and Bruce Johnson, that the markets weren't as good or as deep or as consistent then as they are now. My experience is that the new traders that have come in in the last 10 to 15 years have not gone through that kind of experience. The bond market at the Board of Trade is a good example. Some of our most successful bond traders have known nothing but success from the beginning, and they're great traders. They may have losing days but they never leave the Exchange or bust out, as we say.

I think that the markets have matured to allow that. The markets back in the 1970s and early 1980s would have huge run-ups and huge run-downs. We had rapid periods of inflation and wild volatility and big gaps in the markets, and we still have them, but I don't think it's quite as bad. There's also, in general, a better breed of trader coming in. Don't forget, when those people you mentioned came in, the industry was young and immature, and we didn't have the network then that we have now. Now when somebody comes into the Exchange, there's a network. There's training. People aren't afraid to tell you what to do and what not to do.

Q: When I started, traders refused to train other traders. They wouldn't talk to you about ways of improving your trading.

Pat: Absolutely, so I don't think there's as much of that now. I don't think that it's necessary to lose everything to be a good trader. And believe me that makes me feel good because it's something I went through; it's something that my partner, Henry Shatkin, went through, but you know there are other great traders who never went through it. Lee Stern was a good trader from the day he walked on the floor. He started when the markets were immature, but you see he was always able to take a loss. He never had trouble with that. That was a wonderful characteristic. He just wrote down the loss and moved on to the next trade. But as I said I did have some trouble in those early years. I was inexperienced, and I didn't understand how to trade. I didn't get it right, quite frankly, for quite a while.

Q: Pat, do you think trading is all in the mind?

Pat: Exactly. It's all in your mind. Successful trading is learning how to have the kind of psychology that allows you to overcome debilitating emotions and the attendant distractions in the market.

Q: And yet the public, to a large extent, hasn't gotten that message. They think it's all about purchasing the Delta Signal or Master Trader Software or some delusional system that doesn't have a chance of working.

Pat: I think the Holy Grail is a good example, because we used to have trader after trader, or CTA after CTA, walk into our office with what they thought was the Holy Grail system and I will tell you we didn't have good experiences with these trading systems early on. I do think, however, in the last four or five years that these trading advisors have done better. I think we're becoming more sophisticated and the computer models are improving. Chaos theory seems to be the current rage, trying to make some predictability out of these random occurrences. Actually I find the theory particularly appealing because of my interest in mathematics, although, from my point of view, successful trading always comes down to what I talked about before. Always be spread, have discipline, and consistently chip it out.

Q: Why has spreading been the answer for you in your trading?

Pat: Well, I think part of it is it suited my personality and my particular abilities. But more than that, I found it to be a very consistent way to make money. In spreads you don't have to know if the market is up or down. In fact, many times when I was trading actively in the pits, I had no idea if the market was up or down, all I cared about was the spread differential. I'd be embarrassed at the end of the day when people would ask what the market had done. I'd say I didn't know. But I knew the spread was 1-1/2 to 2. So to answer the question pointedly, it suited my personality. I did not like the swings in outright positions. It didn't make me feel very good when I lost money. It's not that I didn't lose money spreading; in fact, I did lose money spreading, but in relative terms not all that much. Plus the fact that I was able to take a look at the traders who we were clearing and I could identify the successful ones. We had some very fine scalpers on our books. But even the best of them didn't make as much as the best spreaders. So it was clear to me the risk/reward was better for a spreader.

Q: Can you talk about how you use spreading for getting into the market, in other words, how you determine a point of entry into the market.

Pat: The wonderful thing about spreading is you really don't have to determine it! As I said before, all you want to do, if the spread is two sellers, is sell it at two or more, and if the spread is two bid, you want to buy it at two or better.

Q: How could somebody who's off the floor use spreading as a successful trading strategy?

Pat: Well, you can't do it exactly the way I did it then, but let me give you an example of what I'm doing now. Let me begin by saying it really doesn't make any difference how you enter the trade, whether you buy it or sell it. It sounds strange but in truth it's not really important. What is important is how you manage the trade afterwards.

Q: That was my next question.

Pat: So it's managing the trade that's key to your strategy. I may not even have a view of the market, except intuition. Like I bought some wheat, and the wheat wasn't acting too well, so I sold some options but I still kind of liked the wheat.

Q: Why'd you like it?

Pat: What?

Q: Why'd you still like the wheat?

Pat: Well, it had been in a big break and I could see an increase of short interest in the market by the large trader reports, and I thought that the funds were possibly too short. So to allow me to stay in the trade, I sold some just-out-of-the-money options against it. Now if the market rallied, all I could make was the 10 cents premium that I sold the options for, and if the market broke, I was protected for about 10 cents. However, if the market did rally, I would be able to manage that trade more easily. I might be able to buy some more futures and keep the net long position that I wanted or I might buy in the call position.

The point I'm making is all the time I'm hedging, I try to be balanced in my positions. Now I understand that I've got a downside exposure, but it's minimized by 10 cents, and I can stand that! If the market breaks, well, then I'll have to manage the loss. As a matter of fact, the market is breaking right now.

Q: Do you apply the same money management principles to the spread as you would to a net position?

Pat: Yes, I would apply the same principle. If you initiate a trade and it's not working quite the way you like but you do like the position overall, sell something against it or buy something against it. This allows you to stay in the position a little longer. It gives you a second look and you can manage the trade by lifting a leg. Now that suits me. It suits my temperament. It has worked quite well. I spread in bonds. I spread in agricultural products, and I spread the currencies.

Q: How do you spread the bonds?

Pat: The bonds are absolutely terrific. There are so many things you can do with them. For instance you can sell 10-year notes against the bonds, straight out or in ratio. The other day I was trading five years. I got into a little trouble. I didn't like my bond position so I sold bonds against the five years. The ratio at the time was 20 to 8, so I bought 20 five-year notes and I sold eight T-bonds, 30 years, against it. Now the market started to break, but this strategy allowed me to manage the trade, and I ended up making money.

Q: Do you always ratio?

Pat: Sometimes I trade them one to one, but it all depends if I want a little more bang for my buck, if I want to have a little more sizzle. The important point is I'm always protected in the event of a catastrophe. So, in terms of spreading, I trade the 10-year notes, the five years and, to a lesser extent, the two years against the bonds. I also trade the bond options, which you can use the same way. You also have the 10-year note options. Believe me, there are all kinds of sophisticated things you can do. I mean, if the ratio is 100 bonds to 132 notes, maybe I won't sell 132 notes, but 175 at-the-money calls. There are many spreading opportunities that you can take advantage of.

Q: How important is intuition?

Pat: Intuition. Gut instinct. If you have it, it calls something up inside of you in a New York second, and as a seasoned spreader, you know what to do with it! I tell my son, Michael, who's in the bond and Euro-dollar market, that the only nice thing about being older is that we've got a little more experience, a little more of that information stored in us. It's like Mark Twain said to his father. You know, when he was 16 he was amazed at how dumb his father was, but by the time he got to be 20, he was amazed how much his father had learned in four short years.

If you're in this business for years and years, and you've developed good habits and you're honest with yourself, you have instincts. Call it intuition, gut reactions, you learn how to trust yourself! Sometimes when you meet someone for the first time, you like that person right away, there is a natural attraction, and then sometimes after that you start to second-guess yourself. If you stop to think about it, your first impression is usually the right one. It's the same thing in trading decisions. Generally the first thing that comes to your mind, the first reaction you have, to do it or not to do it, is the right one. The more you think about it, the fuzzier the trade gets.

Q: So instinct and intuition . . .

Pat: Get you in and get you out. What's key is knowing you can trust yourself. Everybody's got to deal with markets. It's a question of managing the trade in your own mind. Never exposing yourself to where you can really get ruined and lose everything.

Q: Many traders who trade markets like the bonds and the notes are very fearful of reports. You know, in fact, they find it very inhibiting to be in the market when a major number is coming out. How do you handle that?

Pat: I try to stay out of the markets as much as possible when the reports are issued.

Q: You would even be out of spreads?

Pat: No. I would be balanced. And I might have some exposure one way or the other for, you know, a manageable amount of money . . .

Q: But in fact, that's what your strategy seems to give you. It gives you the ability to handle that.

Pat: Right. Exactly. But I generally never want to be exposed going into a major financial report.

Q: You know, Pat, many seasoned traders either misunderstand or choose not to understand the strategies involved in spreading. In fact, the only time they use spreading is to avoid taking a loss. It's quite different from the concept that you're talking about.

Pat: Yes. That's true.

Instead of realizing the loss, many traders will sell another month or another market against it so that, in reality, all they're doing is avoiding taking a loss on the original trade. In reality what they end up doing is compounding their loss because they start making a series of bad decisions. When I was on the floor, I would sell another month and then I could take my loss by spreading out of it; however, trading off the floor is quite different. I may reverse myself by selling some options against it. It might turn me from long to a little bit short. But it's not taking a loss that causes me to do that; it's managing the trade. If I were to initiate a trade that would turn bad before I could manage it, I'd just take the loss and get out of it.

Q: Are there any particular markets you like to trade?

Pat: I probably have a predilection for the grain markets. I love the bond market! The Euro-dollars don't excite me at all because of the slow movement but it's a fine institutional market. I do look at the Euro-dollar market once in a while for managing monies. I occasionally put on a spread in the Euro market, but it's not something that attracts me. On the other hand, the currency markets do. Since I grew up in the grain markets they hold something special for me but when they're slow like a couple of years ago, I just wouldn't trade them.

Q: Is that part of the discipline?

Pat: Absolutely. I see these young fellows in the grain markets when the market's slow. I say to myself, why would you be here? Why would you be in this pit, and you look around in the pit and there's plenty of room and there's camaraderie, but I'm thinking to myself, if there are two restaurants and one is crowded and one is empty, which one is going to have the better food? The bond pit is crowded for a reason, because there's money being made there. People are crowded in there because there are things happening and there's opportunity.

Q: How do you think one achieves consistency as a trader?

Pat: Learning to take losses is probably the best way to do that. Don't allow yourself to be dissuaded by losses and discouraged or depressed by them, because the market's always there. There's always a market. The main thing is to always be in the game, always be involved in the market, because there will be opportunities. You never want to get yourself in a situation where you deplete your assets, where you can't participate in the market.

Q: Pat, I want to ask your opinion about something that I find fascinating. Many traders spend 80-90 percent of their time analyzing trades and 10 percent of their time actually trading. Whereas the most successful traders seem to spend the least amount of their time analyzing the trade and the majority of their time in the rough and tumble.

Pat: Yes, I agree with that. I remember there was a fellow named Mike McMurray, who I have the greatest respect for. He lives up on the North Shore. He's a bean spreader, very good by the way. He said to me once that it took him about three or four years to learn the business. Then it took him two years to unlearn everything he learned before he could make money. I've seen people around here suffer from what Martin Luther King called the paralysis of analysis. I sincerely don't believe you have to overanalyze these markets. I see people working with these charts and working with these entry points and they've figured out these systems and they figure out dates that you buy grain on, and you sell it on a certain date. Everybody's looking for the Holy Grail; however, it's the instinctive trader, the trader who knows, and is willing to make the trade and has confidence he can manage it, who is going to make money.

Q: It seems to me your trading strategy ultimately is about giving yourself more options all the time.

Pat: Always. Yes. Flexibility. And we've got so many products, as I say. I mean, it's really exciting for a trader these days to utilize all these products that we have. We didn't have most of these things back in the 1970s. We just had futures.

Q: Why do you think success at trading is so difficult for most people?

Pat: We did some studies when we had our discount operation. It is probably due to limited capital. As a matter of fact, we did some studies that indicated that back in the early 1980s. Limited capital, not taking losses, not having discipline. I think to some extent that's changing now, because I don't think we're seeing as many of those small retail traders anymore. There's a concentration of money in the hands of professional money managers. We're seeing a whole change in the industry and the trading advisors are under the microscope and their performance is analyzed daily and monthly and so performance is very important. They've got all kinds of fail safe mechanisms, so, you know, we're seeing less of the individual traders than we saw before.

But of those individual traders that we do have, I think that a number of them are quite good. Someone once described the market as being very seductive, like a beautiful woman that just keeps beckoning you. There are many people who shouldn't be trading who are trading. They think, if that dog can do it, I can do it! You have to have a respect for the market, and the things I talked about, the principles I talked about. . . . I think if you adhere to them, it's pretty much common sense. The markets have this great allure. She is a great temptress. She is attractive and seduces people.

Q: In *The Innergame of Trading*, Leo Melamed compared it to good sex.

Pat: I don't know about that!

Q: Maybe not for you because of all that discipline!

Pat: (He laughs.) I like sex and I think Leo does too, but I don't know if I would go that far.

Q: We've found, Pat, that what someone believes about himself will affect almost anything he does in life, including trading. We were wondering, what does Pat Arbor believe about himself as a trader?

Pat: Well, I have confidence. I'm disciplined. I have respect for the market. I've never thought I was bigger than the market, which is to say, I never had any illusions of grandeur. I was pretty much of a chipper, and I chipped away, and made and saved and invested well, and never had any great pressure upon myself from about 1970 on.

Q: Pat, could we talk a little bit more about confidence, because that's a big issue for most traders. How do you think one develops confidence?

Pat: I think confidence is developed by challenging yourself. Proving to yourself you can do different things. I've seen traders indulge in physical fitness programs, running marathons and lifting weights. I've had traders go into specialized classes. I've seen people come in who were very shy and very bashful and easily intimidated, but they forced themselves to change. And I've encouraged people that had troubles to embark upon any of these programs, whether it's a personal improvement program or whether it's therapy. All these things build confidence. However in the last analysis it comes down to a willingness or a commitment to challenge yourself!

Q: Did you have a role model?

Pat: That's a real good question. In my life I've had a number of role models. Outside the Exchange, Father Kelly, who ran the orphanage that I lived in at 1140 West Jackson Blvd., and my grandfather when he was alive. What these men gave me was a great respect for power and money and strength. They were very strong men, both of them. Their role models have served me well as a trader.

I learned in life that role models are very, very important, and I've had, I guess, what you might call an interesting life. When I needed to be strong, when I was younger, I looked to these role models. I've had other role models. When I did my student teaching at Lane Tech, my student teaching advisor was a fellow named Bill Glickman. He was a wonderful teacher, a Fulbright Scholarship winner. He was very intelligent and a decent man. I said I wanted to be like him, so I started hanging around with him, and he was my role model to be a teacher. Then I went to work for a bank, Jefferson State Bank, and I had a role model there in business . . . a man named Bernie Feinberg, who had a kind of checkered career. But we became very good friends, and he was very helpful to me. When I started in this business, he lent me some money, but I probably learned as much about business from him as from anyone else.

Q: And how did that bear on your trading?

Pat: It didn't bear a lot on my trading, because he was a stock trader and a bond trader, but he did teach me a lot about business and the ability to be flexible, to take losses. He was pretty good at buying and selling real estate. I was always amazed at his flexibility.

I think role models are very important. I think in life, if you want to learn to be more sensitive, you would go and hang around somebody who's sensitive and caring.

If you want to be smart, you would hang around somebody who acts intelligently. If you want to be a good politician, you'd hang around someone who understands and is good at politics. And if you want to be a good trader, you should hang around good traders.

Q: That's why we're talking to you, Pat.

Pat: Well, it's really quite simple, isn't it? It's a wonderful business.

Q: Well, we always say, it's simple, but it isn't easy.

Pat: That's true.

Q: And people tend to make it too complicated, and that's what gets them into trouble.

Pat: One of the great scalpers is Victor Kastil.

Q: I know Vic, we used to play tennis together.

Pat: He's a good tennis player. You must be a good tennis player yourself. Anyway, he makes a lot of money. He's a wonderful guy. His success in trading all comes from the discipline. I mean, he can turn on a dime. Then you take someone like Tom Baldwin, who told me he traded 60,000 bonds a side a couple of weeks ago. When he goes home he won't have on more than five or 10 bonds. He too has great discipline. You see it all comes down to those qualities discipline, patience, consistency.

Q: Pat, what would be your final words of advice to an aspiring trader, somebody who really wants to make it in trading?

Pat: Well, I would be very encouraging. I would say to them to try and develop a discipline about their lifestyle and behavior, and bring those same principles to trading. Don't search for a Holy Grail. Do not think that there's a system out there that's going to be an easy ticket to riches. Adopt the philosophy that you're going to grind it out and make a little money everyday. Let it pile up, and at the end of 10 or 20 years, you'll have something to smile about, and there's an added benefit: You'll know a great deal more about yourself. You're going to learn about your strengths and your weaknesses and what you can stand and what you can't stand. What your character is. You'll find out if being honest with yourself is important to you. For me that is why I enjoy it so much: With each trade I get to learn something new!

Chapter Seven

Anthony J. Saliba

Anthony J. Saliba is the managing general partner of Saliba Partners. He began his career in the financial industry as an independent market-maker at the Chicago Board Options Exchange (CBOE) in 1979. Mr. Saliba traded in the Teledyne pit where he developed his own trading system, which made him one of the most active—and successful—market-makers on the CBOE floor. He is also a member of the Chicago Stock Exchange, Chicago Board of Trade, and Chicago Mercantile Exchange.

Mr. Saliba is CEO of International Trading Institute (ITI) where he developed a revolutionary voice-activated trading simulator, Trade$tar™. Introduced in January 1989, Trade$tar is an effective tool for training and is used by professionals around the world. Mr. Saliba is committed to training successful traders, and currently backs a group of profitable traders.

An exchange leader, Tony served on the CBOE board of directors from 1987-1989. He continues to serve on industry committees and is a board member of assorted philanthropical organizations. He is on the Executive Advisory Board of the Stuart School of Business. Mr. Saliba is frequently mentioned in the financial press; most notably, he is featured in a chapter of Market Wizards *(New York: Harper Business, 1992).*

Q: What first attracted you to the market, Tony?

Tony: At first, it was the independence and the money, basically. I literally just asked around and tried to find out who makes the most money in this business even before I really knew the difference between trading and brokering.

Q: You have been trading now for 15 years; is it still the money that motivates you?

Tony: I think now it's the challenge and the creativity of trading. It's the challenge to come up with an innovative solution or alternative. For instance, you can accomplish similar results by going out and selling a hundred straddles, or working a creative position that involves some diagonal spreads or maybe some butterflies or some time spreads, whatever. But the point is that, on the one hand, there's the easy way. On the other hand, there's a creative, less risky solution that is ultimately more profitable.

Q: What is it that you enjoy most about trading?

Tony: I enjoy when my trading strategy comes together. Sometimes you have a more fulfilling day when the market's been all over the place, and you just get out. You know how it is! Just to get out with a scratch or even a small loss. Like last week, for instance. We do trading in a number of different areas and one of these areas requires a short gamma position. . . . We're constantly managing the mountain, if you will. We have a huge profit P&L chart that shows if nothing happens in the market today, we will have a nice day, which is our theta. But as I was saying, last week the stock that we're trading in suddenly got a little bit active, a little more than usual, and I had to scramble. . . .

Q: What were you trading?

Tony: I was trading options on Merck stock that were on the CBOE, and the stock started to get away. . . . So now the object is . . . if I overhedge here and the stock settles back to where it was, my hedge is a total loser, but I'm positioned so big that I have to do something! So here I was caught in that situation that all premium sellers recognize. . . . The question now is, do I wait to see if it comes back a little bit or do I bite the bullet? Do I scale into it and run the risk of having it get too far away from me?

So, I kind of waited a little for a while, and then it kept inching up. I bought a little bit and got lucky when it settled back, but that day, the bottom line was we were up or down a small amount of money. Maybe $10,000 either way. Not bad when the stock moves big.

Q: We should say that for your company. That's not . . .

Tony: Well, for this account. I think today, it was up 40 grand.

Q: Which would be a single digit incremental change.

Tony: But the point is that it was a fulfilling day, because although I was certainly nervous for a while and thought it was going to be a losing day, we traded the market well and got back to a point where things were safe.

What keeps you coming back is the sense of fulfillment you get by using creative processes to overcome the challenges that the market presents. Another point is trying to utilize all your talents, your resources, in making strategies come together. The advantage of the Institute is having these other traders who are like putty in your hands and then you see a challenge over here, and you say, well, this is what I would be doing if I had the time or the inclination to go in there and do it. Now I feel great knowing I can get this person to accomplish with his trade what I would. I find mentoring people very fulfilling.

I think the bottom line for me is that if I weren't doing all of these things I probably would be in gourmet chef's school or learning another language. Am I making the point that for me, using all my talents and being creative is what it's all about?

Q: Well, I was thinking as we're talking that you just love spinning that chessboard, considering all possible moves. I mean, as I am watching you, you're kind of focusing in six different directions all at once. It's almost as if a geometric thought process is going on. So I do get the sense that as a trader you're constantly looking at the market from the perspective of its infinite possibilities.

Tony: We have a joke around here that I have two brains. I've had girls stop going out with me because my subconscious was always thinking about my position! I'm constantly going over that, but normally, if I were having a meeting with one of my employees, I'd be working on the PC too. I told myself I'm not going to do that for this interview, but I guess I'm just being true to my nature.

Q: What would you say is your greatest strength as a trader; is it that ability to see things from a variety of different perspectives?

Tony: Absolutely, yes. That and the energy level of someone 15 years younger. In fact, while I was in the pit on a full-time basis, I could carry on a conversation and still make trades. I never took note of this ability until 1986 or 1987 when my oldest friend, Rick Schechter, was coming to visit me. He was at the Merc, and I was at the CBOE. I was talking to him, and at the same time I was making trades. I was hedging my positions and talking to him. Rick's from the futures end, and I was doing index options. And he was amazed. He said, "God, you can do all these things at once?" For me, it was perfectly natural, totally relaxed and effortless.

Q: I find that rather amazing, because when I was in the pit, I was just so totally focused on what I did that I couldn't understand how somebody could have a conversation and trade effectively at the same time.

Tony: Were you mostly looking at charts or were you reading the tape?

Q: Mostly reading the tape. I used to look at fundamental information and spread three or four commodities in four or five different options.

Tony: So you were doing multiple things also.

Q: Oh, I do multiple things, Tony, but I can't do them and have a conversation at the same time!

Tony: My girlfriend always asks if she can have a part of my second brain for a little while. I'd be watching Rush Limbaugh doing my chart work, planning my game plan, and have a conversation with her at the same time. I work fast under pressure!

Q: What do you think are the essential characteristics of a successful trader, you know, beyond yourself; everybody wants to know what it takes to be a top trader?

Tony: You know, that's like the Holy Grail of questions. It's a good question, and I don't think that it should ever stop being asked. But I'm not exactly sure that there is an absolute answer!

I think long before it became fashionable to say this, I said that it takes discipline. I come from an options market-making background where my job is to take advantage of market-generated opportunities . . . small ones, as fast and as often as possible. And as risk-free or on as low a risk basis as possible. So in that capacity I'm acting somewhat like a machine or a mechanic. Any creativity you can add to that makes it a little nicer, but it's not that sexy!

Later on, you step it up from there, and you say, okay, I want to take a little more risk, and push it a little bit more, and maybe it starts to get a little sexy, but discipline is always the foundation.

Q: Sexy, meaning you're pushing the envelope.

Tony: Yeah, you're pushing the envelope a little bit and you've got, as they would say, good gearing. Okay, so you have some leverage working for you or whatever, but in answering the question completely, instead of just copping out to that old standby discipline, I think it takes some tenacity. It takes being part chicken hawk. In other words, in your mind, you can't come from a fat and sassy mental environment that you just don't give a damn, okay? You've got to almost be prepared mentally to go out and work for your next meal. Hey, you know what the intense Chicago trader looks like!

Q: Do you really think Chicago traders look a certain way?

Tony: Well, you know, I'm talking about the way we present ourselves, our hair, our dress, everything! But yes, there is something special in a successful trader's eye. You can see he knows what's going on! Definitely you can really see that. I know I can see it.

Q: Like they're street smart, would you say?

Tony: Well, a little bit street smart. Hey, you've been there, you know. Like they've got a skill and they have a certain repose or self-confidence about it and even the up-and-coming good traders, and we've met plenty of them, have that gleam or whatever it is in their eyes. It is a lean and "I'm hungry" look.

I'm thinking about one of our best students at ITI and one of my best friends now. He trades in a Scandinavian country, and he's immensely successful. I mean the guy works for a large bank, and literally made millions trading but he's a fairly new trader. He's only been doing it for about three or four years, he embodies this successful image, this successful attitude. I'm not saying that this has to go on forever, but he eats, sleeps, and breathes trading. He's always searching for ways to raise it up a notch, to improve his trading.

If you're a fundamental analyst in a certain industry sector, there's a body of knowledge that you always want to get your arms around. And then there are the whys and wherefores of that knowledge. You just want to put that information all together. So you feel as though you're at the cutting edge all the time, so that even if somebody just sneezes, all of a sudden, you can see what it might mean to your position. That's not my game; but in my game, where I'm looking for market-generated opportunities, for an edge where things are mispriced, I have that same desire or intensity. And this person I was speaking about tries to focus in on all the knowledge and information base that he can, and that means it's basically a 24-hour a day job for him. You know, he goes to bed thinking about his position and that's how it is for me! I guess that's why there is early burnout for quite a few traders.

Q: It's that level of pure concentration . . .

Tony: And intensity, yeah, it's constant. I mean for me, I just have to, every now and then, go and hit the slopes or go to the beach and veg out. I was watching a program about the Blue Angels this weekend, and these guys do something unbelievable. Most people look at it and go, "Wow, how do they do that?" And then when you look critically at what they're doing, then you really go, "WOW, how do they really do that?" But, if you're a successful trader you know the answer. You know just what it feels like to be a fighter pilot, the cream of the crop. You're the guy able to be pulled out there to a certain unbelievable level of ability. So I say to myself, "In the financial world, I'm a Blue Angel, there are things that most people wouldn't understand how to do or be able to do that I just do!" It just takes total concentration, discipline, and focus.

Q: So, Tony, you're the Blue Angel of options! The guy who looks like he's taking ultimate risk but in reality it's tied to ultimate discipline.

Tony: Most people would think I'm crazy, right? Yeah . . .

Q: . . . but, you know, within your frame of reference, within your frame of risk, from a psychological viewpoint, it's really not that risky!

I had lunch last week with Mark Douglas and we were talking just about this whole issue of risk. Mark was telling me that when he was a boy, he used to go ice fishing in Michigan, and he used to go way out on the lake. You know he never considered that risky. Because people up there would drive their cars out onto the ice, because they would know that the ice is 18 inches thick. In the winter, Mark still takes walks out onto Lake Michigan!

Tony: I wouldn't go out there!

Q: Exactly. Too risky right? But Mark made a really good point. He said, you see, it's like the market. Most people think this is risky. But for Mark, it was never risky, because he understood the lake and you understand the risks of the positions you take.

Tony: Yeah.

Q: Well, the point is, whether he understood it or not, in any absolute sense, I mean nobody ever really understands the market. Like no one man ever understands women, but, God knows, we try.

Tony: You never know for sure!

Q: Exactly, but you can make some. . . .

Tony: Fair judgments.

Q: Some fair judgments based on your experience and your knowledge and your state of mind. So I think . . .

Tony: You've got to have your niche.

Q: Exactly.

Tony: Well, it's funny because basically, for the Institute, we founded our entire premise on this risk stuff. To the average person, it's beyond comprehension!

We asked ourselves: What other industry is like trading? We came up with flying. And that's why we adopted a flight simulator type of approach to teach people how to trade. But when you're flying, you've got to be strapped in so, of course, the risk is always quantified. And so the difference between what we do and what, for instance, a guy like Soros does is I mean, for him to lose $600 million on that yen trade means that he had to assume risk! But it's really comprehensible if you have $6 billion under management. It's just more zeros! You have to strap yourself in at your level of acceptable risk.

Q: Let's talk about strategy and its importance to your trading.

Tony: Well, to draw an analogy that's proper, it's like any sport, okay? Pick one. Let's say football. They can go out there without a playbook, and they can still win. I mean, it's possible. Sheer brute force, luck, misfortune on the other team, whatever. I mean, we've all done it in our pick-up games, right? But ultimately it's the team that's most prepared with the best strategy. Victory goes to the team that has a game plan that can be consistently executed. The same holds true, for instance, in college basketball. There are some teams that play street ball, and they're just big and they run and they score a lot, and at the end of the game somehow they manage to outscore their opponents. So possibly you have unlimited amounts of capital or you can move the market around because of your size, but to be successful, you have to have a plan, a strategy that has a beginning, a middle and an end, and that strategy has to make sense. And what I said earlier about us being mechanics in trading options, there's an art and a science to it. And the science is the doctrine. . . . It's the easy part, and that's where the discipline comes in, and the strategy has to fit within that science; how you apply it is your art!

Q: Could you talk a little bit, Tony, about how your trading strategy applies to you personally? Why did you choose options out of a universe of trading possibilities?

Tony: And I did try other things but . . .

Q: Talk a little bit about that.

Tony: Well, okay, to say that I have any, you know, magical Holy Grail strategy would be false. We subscribe to some strategies that are fairly common, and we just apply them in different ways. . . . That's the art! But in the beginning I looked into and tried a number of different things. I read books on Dow theory, and I was looking into being a technical analyst, and trying to just learn how to read the market.

Q: When you say Dow theory do you mean Dow Jones theory?

Tony: Right. Not the *Tao* [pronounced "dow"].

Q: Actually, I'm not sure which one would have been more helpful.

Tony: Probably the Tao!

Technical analysis didn't work for me because, you know its just so hard to forecast. And then we tried lots of fundamental analysis . . . which industries look good and that basically means you just become a stock picker.

So for a year and a half or two, I actually experimented with a lot of different strategies, and then when I got down to the floor, I also tried a number of different strategies that were popular at the time.

Q: So basically you worked hard to develop your strategy. It was not something that came to you, you know, in the middle of the night in the form of an apparition.

Tony: Right. Well, what happened was, I heard about certain strategies other traders were using with good results. And basically, what it boiled down to was the strategy has to have a beginning and an end. Usually, the beginning is, you execute a trade. In actuality, you really should make your second trade first, because when you're making the trade, you already know where you're going with it. That is, where and how you're going to hedge it. And for me, that's the beginning of the process of building a position.

This allows you to get into the market and manage the trade. I mean, you're thinking about money management from the minute you're in, so you hedge! I think what often happens with people who are looking for ways to improve their trading. . . . They're hearing all these voices all around them telling them there is this Holy Grail, just this one way to do it, and so money management becomes an afterthought to the whole process. As you know, there's a whole industry out there that's just based on finding the one methodology, and it seems to me that's not what trading's all about.

Q: Amateur night trading!

Tony: That's, what I call the hobby approach to trading. "Win the Publisher's Clearinghouse Sweepstakes, find the methodology that works for you." Great trading is all about management. It's money management and strategy management.

Q: Well, maybe what we could do since, as you know, this book is about strategy, is focus on what you feel are the basic elements of your trading strategy. How do you personally decide when to enter the market?

Tony: Keeping in mind that we have a number of different trading entities, depending of course, on which entity you're speaking of, I would say, predominantly, value determines where we enter. When you're required to make a reasonable return on $50 million in capital, it takes quite a bit of daily return. In this strategy, we are looking for the ability to sell premium without having our butt handed to us if we're wrong. The question we ask ourselves is the ultimate question: Is the volatility the right level to begin to sell? It takes analysis, historical analysis which, with one political announcement, you throw that away, too. You start to lean on certain indicators, and you try to fine-tune what you come to depend upon. For example, during NAFTA, things really got pumped up, and I don't think any of the guys around us were willing to admit that this was the big chance to sell premium. In actuality it was the best selling opportunity in years, but not a lot of us took more than a small amount of risk to do it. We let a great opportunity get away. So entry again is the art of it that says, okay, look at what your science is telling you and then factor it in with the political and financial news that's currently in the marketplace. But . . . in the whole scheme of the plan as you think about your entry, the question that has to be asked is all about the exit . . . what are our possibilities with this trade.

Q: So in your strategy entry's always based on value, always keeping in mind what your exposure is and where your exit is. In other words, you're always thinking about exit before you even enter the trade.

Tony: Yes.

Q: In essence, you're hedged as soon as you get into the market?

Tony: Pretty much. Well, there was an interesting piece in the editorial section of the *Journal* last week by Richard Breden, who says "hedged is a relative term." Oh, yeah, we're hedged on that stuff, but you know, really, it's just that we think we are. We hope we are, but . . .

Q: You never reduce the risk totally, or else it really wouldn't be a game.

Tony: Right. You can't reduce the risk totally. There are those who try to reduce the risk totally and then the game's over.

Q: They do a reversal and they're done.

Tony: Right, exactly.

In the early 1980s there was a saying that option traders want to pick up the dimes in front of the bulldozers. The dimes are everywhere. They're lying on the ground just waiting to be picked up. There are some traders who look all around them and say well, how could that be; I can't believe it; it's too good to be true! And that, I think is the interesting part. There are other people who look around and say it's not enough for me. I'm not going to bend down unless there's paper money!

Ultimately it's a matter of what you see and how hard you want to work. I believe that, first and foremost, the commitment to work hard is fundamental to being a successful trader and to developing a trading strategy that will work. The reason I say this is obvious, nothing comes easy . . . at least it never has for me. And I find that our hard work is usually rewarded. So we're bending down, picking up dimes and nickels and quarters all day long, and we've got to do a lot of bending, but we make it a point to stay in shape to do that!

Another friend of mine who is an expert on market timing looks for 12 trades a year tops. Usually eight to 10 trades. He's in there for the trend, and that's where the big CTAs make their money, because they can't move their stuff in and out fast enough. Okay? But, for us, our point of view is different. Our horizon is shorter. We see many strategies that will make money, and one is that there are a lot of little bits of change in the market all day long. From where I sit, scalping 12,000 shares of stock for an eighth is just as good as buying a thousand shares and riding it for a point. And, of course, as you know, Everett Dirksen said, "a billion here and a billion there and pretty soon you're talking about real money."

Q: You started talking earlier about discipline. What does that mean to you?

Tony: Well, first of all, it's not denying yourself. It's not getting down on who you are and raking yourself over the coals.

Q: Is it honesty?

Tony: Yeah. Being honest with yourself, okay? That comes along with the discipline, but really, where the rubber meets the road is just being able to pull the trigger and stick to it, avoiding all the many psychological temptations that are swirling around in your head.

Q: Why is it so hard for so many traders to pull the trigger?

Tony: Second guessing themselves. Even now, in my older years upstairs in front of the screen I find that I'm a little gun-shy at times. I say to myself, "I can't sell that 50 lot there." But what's key is just to do it. Make the trade. Being able to read the playbook; stick to it!

Q: So, then Tony, what is the winning strategy? Locating value, having good money management, identifying a point of entry, and being disciplined . . .

Tony: Yeah, and doing all those thing fast. Being there! Finding it first and executing it properly . . . hedging it as quickly as necessary. I mean, hedging it at the optimal time, okay? Not always hedging it fastest is best, but you have to know your limits. You must hedge it within your framework.

Q: When you say framework, what do you mean?

Tony: Within the risk parameters of your account. I put together a manual for the Institute about a year and a half ago and pretty much just unloaded all my ideas about traders and the appropriate risk management. It's a doctrine. It has 50 questions to ask yourself. . . . Basic stuff like, "Why did I make that trade? Why am I overextending myself? Am I using enough of my capital? Am I being too much of a wimp and not pushing the envelope enough?" So to get back to your original question, the discipline, the winning strategy, is having the confidence to locate value, hedge it properly and mold the position in a way that makes sense for you or the institution.

I know I'm speaking in general terms but I also know this formula fits everyone. Recently we were teaching someone at Deutsche Bank. We were teaching how to walk a straight and narrow line. And his attitude was "Hey, this is the Deutsche Bank, we need to take more risks, because we need to make more money." So we said add two zeroes to what you're doing but still stick to the discipline within the needs of your institution. It makes sense.

Q: Isn't that also what patience is? I mean it's a cliché, no, really, it's a truth.

Tony: Look both ways before you cross the street. I've heard it a million times, but you know what? I almost got hit by a car the other day. I was walking across Franklin, talking on the telephone with a trader upstairs, and I didn't notice that the light changed. A car just came down off the ramp, honked his horn, and missed me by about two or three feet. It scared the hell out of me! My little four-year-old nephew said, "Uncle Tony, stop, look, and listen, right?" It's a cliché! How many traders follow the market truths?

Whether you're Deutsche Bank or Banker's Trust, you still have to know your risk. You've got to watch that you're not at $150 million or $200 million worse case scenario. And if you're a trader on the Merc and $10,000 or $20,000 is the limit that you can risk during the day, you must stick to your discipline and button it up at that point and be prepared to move on.

Q: There's another point here I would like to talk about: Contrary to what the public thinks about trading—that it's very complex—at its most basic level it really is pretty simple, isn't it? I mean, it's never easy, but it is . . .

Tony: It's, funny, because there's a lot of money to be made in complexity, and there are houses that specialize in that, but I think you're right, the underlying theme is getting back to simplicity. The best position in the world is "flat" with a profit in your account! I mean, you can ask anybody at O'Connor or CRT or any of the big houses. Would they rather have positions out two years at varying interest rates or currency risk, or would they rather have realized the majority of their profit and be flat? You're right, it's back to simplicity and basics. Getting there is the trick!

Q: It's like Nintendo.

Tony: For some traders it really is Nintendo. Our traders in Germany are "keyboard Jockeys." They are just focusing and reacting to information flow. They've got a tape to read and news to watch and they're just moving in and out based on what they see. They don't have anything to worry about when they go home at night. They're flat, and if the next day's a slow day or they don't get a good feeling, they just don't play.

Q: Now that's discipline in itself!

Tony: Yeah, that's something that we teach here, too. Don't just trade for the sake of trading. There are good trades and bad trades and no trades! There's nothing wrong with letting a day go by where you don't trade. Now, of course, if you have open positions, you have to manage and mold and work with them, but that's a different story.

Q: I want to ask you about something that you had said earlier: that trading is a science and an art. When you train traders at ITI, what do you emphasize, the art or the science?

Tony: Our traders are getting all the science we can load them up within such a short period of time.

Q: Can you teach them the art as well?

Tony: Well, that's the real question. The long and short of it is, it can be transmitted. It's like the story where the guy goes to the doorstep of the Zen master, and says, "I just want to learn from you." So he just hangs around and after a time something unspoken is absorbed. If you stick around traders who are good for long enough, the art of it comes through. The art also comes through in our anecdotal presentations. As you know, all of our instructors are traders who can convey their own experiences to their students. To teach the art is much more difficult. You can only start to elicit it and bring it out in some degree and it's a kind of gestalt-type thing where these guys say, "Ahhh haaa." It's the ahhh haaa aspect.

That's exactly what trading is. That's the art. It's ahhh haaa. That's the psychology that the public just doesn't get. For the public, there's one master plan methodology. But there's not. You know there's like a hundred ways to find your way into the kingdom, and that is the art of trading.

Q: Let's talk about taking losses. As you know, some people just can't take a loss.

Tony: I was told early in my career that your first loss would be your best loss, and I didn't understand it. I didn't believe it and quickly, within the first three months, I had a big loss, a sizable loss, given my capital. And then, it's like the first time you fall off a horse or fall down on the ice when you're skating. You think to yourself that you hit it hard; but if that's as bad as it can get—and it was pretty bad—at least I lived through it. I said to myself, "Now I'm going to start nipping my losses faster, because they're little bits of poison and if I'm gonna survive I have to learn how to manage them."

Q: When you said that to yourself you were really. . . .

Tony: I was going to walk in front of a bus!

Q: So what got you off the ice?

Tony: Well, I had a very large position on for a new trader and I contemplated just going in and . . .

Q: That was a time you really had to be creative.

Tony: Yeah, well, the thing is I looked around me and said to myself, "Wait a minute; I may not be anything but for sure I'm not the worst guy in the world either!" I felt for sure I was probably in the middle of the pack, intelligence-wise or whatever. I knew one thing: I had a lot more ambition than the average guy.

There were guys on the floor that were making it, and I said, "Well they're doing it. . . . So there's got to be something there." I just knew my ambition and tenacity would get me through.

I met a few guys who were successful and I asked them what worked for them. I took a little bit of their ideas and put it all together and developed some kind of a plan that worked for me.

So I gave it one more shot, and I did this very regimented, disciplined, lock-step sort of trading.

You see, before I had this experience I was looking at the business from the wrong perspective. I mean, it's a business. Before that I looked at it as if it were a get-rich-quick scheme. I looked at it as if the market was like a monumental animal, like maybe a whale or a big elephant that I was going to try to ride. This thing was going to make me a lot of money if I could just stay on it, and I didn't really understand what was making the thing move. Another big term around here is "do your break down" and that means break trading down to the basic components of what makes up this business. So I started looking at it as a business and I said, "All right, I've got expenses that I've got to cover and, at a minimum, what do I have to do to cover those each day?" That's what got me regimented and disciplined in my trading.

Q: So, if we could break your answer down a little bit, you start with a goal that you could attain each day.

Tony: Right.

Q: . . . and you said it's like my basketball coach used to say, "You can't think of the season. It's the game. You start thinking about the season, and you're . . ."

Tony: You're out of here, right?

Q: You start thinking about the game, you're a loser! You've got to think about the next two minutes!

Tony: Right.

Q: And at the most, you're thinking about the quarter, but you've got to think about what you are doing when you get the ball.

Tony: You think about each play. You're right. You're running down the court, and you're setting up each play.

Q: So what you came to see . . .

Tony: I broke it down to the day . . .

Q: You began to say, "What do I do that's going to work right now right here?"

Tony: Right. Just day-to-day. I mean, in a lot of ways we still do that, because you've got to . . . that's the management part. You always keep your eye on the ball day-to-day.

Q: Would you say that philosophy is still guiding your trading today?

Tony: Quite a bit, because as I bring in new traders, I have to instill the basics in them.

Q: So Tony, if you could just break it down to its bare bones, since you've gotten off the ice, what would you say is your winning strategy?

Tony: For me, specifically?

Q: Yes.

Tony: Well, I think the winning strategy for me is to stick to an options trading strategy that I feel comfortable with because of my personality, and to have quantified risk. Even in a worst-case scenario, I mean, if we have Armageddon, we still have it quantified. And within that framework I try to exploit the opportunities that come to me on a trade-by-trade basis. Also I don't overtrade.

Now, that in and of itself isn't the recipe for someone to be successful. I mean you cannot just go out and copy what I'm doing! Those who are somewhat in the know will understand what I'm talking about. You have to find your own way. However, my advice would be to get yourself a sound pricing model and trade every time you get a signal. I mean, I don't think initially that there is much more art involved in it than that. I can say that because basically we look for lots of trades, lots of mispricing in a number of our accounts. Then in some of our accounts we're looking at more long term, and right now you're catching me at the beginning of dabbling in new emerging markets, so we're doing our trading in an old-fashioned way, a wild-west way, but the same rules apply: Watch your entry, quantify your risk, and take it on a trade-by-trade basis.

Q: Tony, do you still love trading as much as you did when you first started?

Tony: In a different way, yeah. Well, see, I took some time off to build ITI, so just in the past 15 months or so, I've gotten back to it, and I do. What I like is that we're bringing the power of these little babies [pointing to his computers] to the marketplace. It's something we didn't have, you know, in the 1980s . . . to be creative and to do certain structured things that only the big banks were able to do before.

Howard: You mean the computing power?

Tony: Computing power. Yeah, I'm sorry.

Q: Where do you see yourself in 10 years?

Tony: Okay, I can tell you five, because I've thought about five a lot. Ten is tough. In 10 years I think that possibly I would just be consulting somebody else who's running the company, because we have some pretty big plans. I mean, we are marching forward in the internationalization of our trading, and this year we'll have three other countries other than the U.S.

Q: But I mean the real risky stuff. I mean, in five years are you married? Do you have kids?

Tony: Funny you put it that way because that has been the risky stuff for me! Yeah, I've put that off these past 12 months. I started living with a woman for the first time. It's been

10, 11 months now. And for those who know me after having not seen me for a long time, they can't believe it. I was always, you know, Mr. No Commitments. But I always knew that I could do it. I just wanted to wait for the right person to come along. I spent last weekend with three of my nephews. I took them to the Bulls game and to the circus. It was a great time.

Q: Tony, in your opinion, what do you think your edge is as a trader?

Tony: Energy. The intensity and drive to be successful. That's the gift that I was born with. When you look around you see there are such a large number of failures . . . There are so many traders who don't succeed. You know to this day I thank my mother. I think I got my drive from her pushing me. For the past twenty years I've only needed four hours of sleep a night. I think I just never slept as a child. I just always wanted to be up. I built a stereo when I was about 14, 15 years old. Stayed up all night soldering things and just being excited about everything I did and thought about.

I do want to say one last thing, a trader really has to have an ability to be knocked down flat on his back, or face down on the ice. And then have the ability to come back. I think it helps coming from a background where you have experienced hardship before so when your back is against the wall, hey, you've been there before! In addition, the trader has to have resolve, the intensity to really want to make it and be there. . . . You have to be able to embrace the stress of it. Be able to get in touch with yourself and choose to endure that stress, make it positive and springboard off of it. You need the science of trading, but the success comes from the art side. It is the heart and soul of the trader.

Chapter Eight

Jeffrey L. Silverman

Jeffrey L. Silverman is an independent trader and member of the board of directors of the Chicago Mercantile Exchange. He has 25 years experience as a position trader of futures, options, and cash commodities with extensive experience trading a broad range of financial and physical derivatives.

In addition, he has been an active participant in exchange governance, serving as chairman of the following committees: Managed Funds and Derivatives, Joint Marketing Subcommittee of the Financial Oversight and Agricultural Oversight Committees, New Products (physical commodities), and Agricultural Options.

He holds a bachelor of science degree from the Massachusetts Institute of Technology with a concentration in economics and finance. While at MIT, he studied with Paul Samuelson and Paul Cootner ("random walk" theorist). He was associated with Commodities Corp. in its formative stages.

Mr. Silverman describes himself as an active student of the philosophy, psychology, and general theory of markets.

Q: Jeff, in *The Innergame of Trading*, you had mentioned that what had first attracted you to the markets was the sense of independence that you were able to get from trading. Is that still the major attraction for you in trading?

Jeff: Well I think there are really two things that are most attractive about the futures business. One is the ability to be totally independent; I come and go as I please and focus my efforts where I want to. And the other aspect of trading that has been very attractive to me is the leverage. A person can turn a very small amount into a large amount of capital in a relatively short period of time. There's an old joke that the way to make a small fortune in commodities is to start with a large one. However, notwithstanding that joke, if you start with a small amount of money and work diligently, you can turn it into a large amount of money in fairly short order. In my mind, there's no problem at all with turning almost nothing into several hundred thousand dollars. The smart thing is to be able to know how to get out before it goes back to zero. Believe me, it took me a number of round trips, too many, before I learned that lesson. So my hat's off to Hilary Rodham Clinton! She learned quite early how to get out before her position soured!

Q: I have the sense that she must really enjoy a good roller coaster ride.

Jeff: She must?

Q: Yes.

Jeff: It very well may be that she's a much better trader than we give her credit for! (He laughs.)

Q: As you think about your own trading, Jeff, what do you still enjoy most about trading?

Jeff: Well, we're still back to it's a hard way to make an easy living. It's a challenge. I view trading as a game and money is how you keep score. It's you against the entire world. It's your job to figure out how you're going to wrest a profit from the marketplace, which is a very anonymous way of saying all the other players in the game. I don't use the term game as if this were something to go play at and to be a dilettante at. This is a business but it's also a game, a very serious game!

You know there is a book by Gerald Loeb, *The Battle for Investment Survival* (Fraser Publishing Company 1988). In trading the futures markets, the very existence of the leverage makes the battle for investment survival very hazardous, even though futures prices, on the whole, are anywhere from a third to a fourth as volatile, in a statistical sense, as stock prices. I think that fact is one of the reasons why I am so interested in this whole investment area. For a considerable period of time I was not successful, until I learned to give up the idea of swinging for the fences, until I learned not to utilize the full extent of the leverage that was available to me.

Q: How do you think your trading goals changed over the years?

Jeff: When I didn't have any money, I traded to make money. Now, you know, I am certainly trading to make a living and my lifestyle has changed, but I have accumulated a fair amount of assets and paid cash for everything I own, so I no longer have to make money in order to live. My lifestyle isn't going to change whether I make money this year or I don't.

Q: What do you think is your greatest strength as a trader?

Jeff: My willingness to challenge the other participants in the market! I am willing to be out there alone with a particular viewpoint. When I've done a considerable analysis of the fundamental factors that drive the market I will wait for the market to convince me that I'm either right or wrong. I'm very comfortable having a position that's opposite what most people would consider rational. It's been my experience that following conventional wisdom will lead you to dismal failure as a trader.

Q: I want to note that there's a bear on this week's cover of *Newsweek* magazine. Typically we see a bull on the cover of that magazine and the market breaks. So I'm wondering if the recent decline in the stock market is going to stop here on the basis of that cover article. What do you think?

Jeff: I would say that the existence of one or two covers like that would significantly indicate to me that there is a high probability of that occurring. In fact, a strong probability that the worst of any decline has been seen and the securities market will wake up to the fact that higher interest rates, the very early stage of higher interest rates, are in fact bullish for the economy and are an indication, a coincident indicator, that the economy is doing quite well. My sense of the matter is that stock prices will do well in that environment. What we've seen is what you could perhaps describe as keyhole theory. When everybody has been long too much of a pile of assets, whatever class of assets, and they all try to get out the door through the same keyhole, it gets mighty crowded!

We had a very quiet, low volatility stock market and bond market in all of 1993, with markets gradually inching higher with no volatility or breaks. As a consequence of the lower volatility, everybody was comfortable with much larger positions than they probably should have been carrying, given financial asset prices at such a high level, so with the slightest whiff of change you have all the longs rushing to exit at once. So who is going to buy if everybody has already bought? Currently, we've resolved some of that problem and we probably are going to see some reasonable stock market action from here on in through the end of 1994.

Q: In your opinion, how important is having a well-defined trading strategy to becoming a successful trader?

Jeff: I don't think that someone can succeed in any field unless he or she is has a highly developed, systematic approach that he or she is going to follow. You need a strategy in order to act with discipline, in order to act with confidence. If you don't have a well-developed strategy you operate willy-nilly, without a considered plan of operation, and of course, you won't have any chance of being successful!

Q: Focusing for a moment on that particular point, what does a successful trading strategy look like? In other words, what are the elements of successful strategy?

Jeff: Well, I don't know what the elements of other people's strategies are, I can only speak to what I think are the critical elements of my trading strategies. I think we're back to some kind of deep, underlying, philosophical set of beliefs. I approach the futures business with an idea of, "What am I doing here?" "Am I really making a living because I'm just playing a game, or am I making a living because I'm doing something that benefits the entire economy?".... I think we've discussed this before, the fact that you don't succeed in this world unless you're providing a utility, in the economic sense. You don't succeed as a futures trader unless you're buying low and selling high. You don't succeed as a trader unless you're buying when there are temporary gluts of supply; a temporary glut of stock index futures contracts caused by liquidation from excessive long positions or a temporary glut in the cattle market because the weather was good last winter. You have to buy when there is a big supply around and you have to be willing to sell when there's a shortage.

Q: Why is it so hard for most people to be able to develop a strategy that capitalizes on that point of view?

Jeff: Well I think one of the key barriers goes back to the issue of independence, the willingness and the ability to stand alone against the crowd. When you think the timing is right and you have a series of pragmatically determined timing indicators that you've developed through a thorough study of a particular market's behavior—not that those always work, you must be committed to act!

Q: I know you're a firm believer in preparation, and as we begin to focus on what your strategy is, could you talk a little bit about the kinds of preparation that you undertake before you get involved in the market?

Jeff: You know there are varying degrees of preparation. Since I've been a trader of agricultural commodities at the Mercantile Exchange for so long, I subscribe to all these terribly esoteric magazines. The postal person who delivers them must really wonder what's going on when he sees *Beef Magazine* coming to my lakefront high-rise apartment or *Hogs Today* and so on. I get *Cattle Buyers Weekly* and a host of other narrowly focused magazines aimed at agricultural producers. I get them so I can understand what is going on in the minds of the people who produce the agricultural commodities that I trade. I also read extensively in the Exchange library and of course, I keep my eyes open!

Q: It is pretty clear from your response that a great deal of study goes into your analysis, plus of course you get the pleasure of reading *Hogs Today* and *Beef Magazine!* But what happens next? How do you formulate your strategy?

Jeff: I'm constantly modeling what I think the various sectors of, say, the meat industry are doing. I try to figure out what is going on in the production side of agriculture. I try to figure out what is going on with the processors, what they're likely to be doing. I try to figure out what is going to happen in the hearts and minds of the other speculators and I try to figure out what is going on at the retail level with consumers. Then I look at what's different about the current environment. The war we had in the winter of 1991 had a dramatic impact on the cattle market.

Q: Are you focusing on time or price? What is the focus of your attention as you read these periodicals and you see some major event which will have an impact on your market?

Jeff: The focus is on the ebb and flow of supply and demand. And if you're going to accumulate goods for a war, as General Schwarzkopf said, "On January 15, 1991, I want to have 90 days' supply of meat on the ground." Well, you have to buy it sometime, so they bought in the fall of 1990. And then when the war lasted only 20 days, they had all this meat and they had to get rid of it. We had a shortage of meat in the fall and then a glut of meat in the late summer and so on. This is an important piece of information.

Q: Can you give us an example of how you utilize your strategy? Can you walk us through one of your trades, perhaps one that worked out or maybe one that didn't work out? And at every step of the way, what were you looking at and what were the critical elements of your strategy?

Jeff: I'd like to take a moment to talk about something that I think, right now, is developing into a trade. I do not know yet, of course, whether it is going to work out in the very near future. In any case, I think it is one that might prove to be very interesting. You know a few weeks ago George Soros was reputed to have gotten nailed on the short side of the yen when the Clinton Administration with their open-mouth policies decided to talk down the dollar and talk up the yen.

Q: Well, he got nailed for I think $600 million but he lost only 3 percent for the year. A small nail.

Jeff: Though, when that happens, whatever the size of the nail, a light bulb goes off in my mind. One of the smartest traders in the world thinks the yen is no good.

Now maybe timing-wise, he's off. As I mentioned in an earlier interview, Roy Simmons who was, as you know, one of the classic guys on the Exchange, traded for over 50 years and reputedly never made less than $1 million a year. He had this card in his pocket, a constant reminder to himself. It read: "Timing is everything."

So the question that's posed in my mind is maybe Soros is right, only his timing is wrong. And now I'm thinking in terms of what I learned from reading a book like Peter Lynch's *Beating the Street*, that everybody can find the next new home run stock in his own backyard, if he's looking hard enough. . . . I'm now seriously thinking about the yen and I happen to go to Florida to visit my in-laws and I rent a car. I get a Ford Thunderbird with a V-8 and this car drives better than my pricey BMW. I'm thinking to myself, the Germans and the Japanese are going to have problems!

If I can recognize that this Ford Thunderbird is better, it's going to take a couple of years, but the rest of the American population is going to realize that American cars are now right up there and surpassing the imports, in terms of quality of ride and other physical comforts, and they're doing it for a substantially lower price. The T-Bird is telling me that maybe Soros is onto something here. Maybe I want to be short yen, long the dollar, for the next five years!

Q: And if you're wrong, Jeffrey, you can buy a $100,000 Thunderbird rather than $100,000 Toyota. [In *The Innergame of Trading*, Jeffrey said there were times in the market when he got too euphoric. He always knew this was the case when he began buying cars. He mentioned that, as a result of euphoric trading, he owned several $100,000 Toyotas. Not that he paid $100,000 for the cars but that they cost him $100,000 through trading euphoria.]

Jeff: So finally the real capstone on this whole trading idea comes from something I read in the *Wall Street Journal*. By the way, I've been reading the *Wall Street Journal* every day of my life since I went to MIT in 1964. Of course, I don't buy the market just because they say buy. In fact, I probably sell when they say buy. But that's my personal strategy. But there was a rather obscure article talking about an oil trading operation in Japan that just took a $1.6 billion loss.

Now this was an interesting discussion in light of the fact that Japanese importers and exporters had been rolling forward foreign exchange contracts that are at historical price levels. In other words, they had a loser on, they were short the yen from say 60 cents and now the yen is at 97. They kept rolling that foreign exchange contract forward, and they had to ante up all kinds of money at the bank to let them continue to roll that contract forward so they don't have to realize the loss. It's an open trade loss and it just gets bigger and bigger over the years. Finally the Ministry of Finance over there said enough of this. You are not going to be allowed to roll forward existing foreign exchange contracts at the current price level. I think that this is probably what blew out George Soros and all the yen shorts, because now all these positions have to be marked to the market and traded at current prices. March 31 is the end of the fiscal year in Japan, where no one wants to be the last one to bite the bullet to get out of this ridiculous loser! Remember, they've been in these positions for years. Now, they're gone. So I see that at present we have a time period where we have a huge amount of yen buying and dollar selling, which has overwhelmed the world's greatest speculator. It doesn't mean he's wrong in the long term. However, it means that right now the yen shorts were big time wrong and they're out. And if the last short is out, that's important information!

Q: Based on your perception, Jeffrey, how would you design an effective strategy to be utilized in the market?

Jeff: Well, we're back then to issues of discipline and money management and being able to sleep at night.

Q: Could you walk us through the actual trade. How do you enter and exit the market? What kind of money management do you use?

Jeff: First of all, for me, when I decide to enter or exit the market, I make a very broad-brush decision. Okay, the broad-brush decision we're talking about here is the yen is in the process of topping out. And I say to myself, very smart people have probed at it and have gotten burned. But the fact remains the yen may be topping out and we see all kinds of long-range economic forces that will push the yen back to equilibrium. Because things have clearly swung the other way. Maybe a Big Mac in Tokyo costs $8 or $10. I don't know. And it seems to me things need to get back in line with reality!

Once I've decided to sell the yen, I've got to look for the best time and place to sell. The best time of course is when everybody else is panicking. The other day, for whatever reason, on the resignation of the current Prime Minister, the yen was up 150 points. So I say to myself that this is a good time to sell. Everybody is buying, so I think I'll sell. And then I ask myself, how much do I sell?

Q: The quantity?

Jeff: Exactly. I have to consider the volatility of the yen. How greedy am I? How willing am I to commit my resources to the yen market?

Q: How do you arrive at a specific quantity? How do you determine how much, and I'm not looking for a specific number, but how does Jeffrey Silverman determine how many yen contracts he wants to sell for his own account at a given point? What's the intellectual process. . . .

Jeff: I think I can go through that in some detail. You know, in markets that I'm comfortable in, that I know intricately, where I understand the fundamentals inside and out. . . . I think I know more about trading the back months of agricultural futures and options on agricultural futures than anybody else in the world. I am very comfortable carrying very large positions. And you know what? I'm right some of the time and I'm also wrong some of the time. But the point is, I'm comfortable making large expressions of my opinion. In the "ags," as they used to say in the meat business, "You sell it or smell it." If you have an economic surplus, you can't hold it forever. You put it in the freezer and you still have a limited life. Prices will approach economic equilibrium much faster than something like gold or copper or currencies. In currencies for instance, you just put them in your bank account and you draw interest. And even though the value of that currency is changing all over the map, you don't worry about that because it's not like you have to sell it.

This, in fact, is one of the reasons why I gravitated in the first place towards products that are more strictly determined by supply and demand: less determined by politics and by the vagaries of capital flows in imports and exports and all kinds of other things that don't directly point to a single supply and demand balance.

Q: Are you sure that it's not that you really enjoy reading *Hogs Today?*

Jeff: No! If yen were that simple, I'd trade primarily yen, it's a much bigger market and D-marks are a huge market. However, given the fact that the amount of capital I have is certainly enough to trade the agricultural markets in a big way, it's not that important to me right now to trade in George Soros' ballpark.

Q: Let's get back to the yen, Jeff. How would you determine what kind of quantity you'd want to do on that trade?

Jeff: I have a new heuristic that I am using for trading financials and it relates to the underlying volatility of the market. In the last couple of months we've seen yen open up to the point where it moves 300 points in one day. The other day it moved 150 points. If I trade 100 yen and it moves 300 points against me, that's $360,000. That's rather more than I am willing to commit myself to for a probe. So now I say to myself, okay, considering that yen might go down 40 or 50 cents and it can move around at any time with noise of two or three cents, maybe I'd be comfortable with being short 50 yen. And then thinking about it and saying to myself, I don't want to wake up Sunday night at 2:00 in the morning and go look at the screen to see how my yen's doing. So I dial that down in half. In fact, I actually sold 25 contracts of yen at the Exchange rather than have anything on that I have to worry about. I think it's critical that no matter what happens, even if it opens 300 higher tomorrow, I still want to be comfortable with the fact that I'm short a unit that I'm willing to sit with and roll. . . . It is a position that I'm going to be willing to roll into the future for the next four or five years because in my estimation the yen has been severely overpriced for a long time.

Q: So you're thinking four or five years out on a trade like the yen?

Jeff: It might take that long for the market to realize that these prices are totally unsustainable. We're doing a damn good job of making our economy extraordinarily competitive.

Q: How's the trade working out so far?

Jeff: It's a scratch. But I'm having a lot of fun with it. It was 30 points against me going home one night. But when I got up at 6:00 in the morning I saw I was 70 or 80 points ahead. But part of this whole game is not getting excited one way or the other. Excited or depressed! You know, the pronouncements coming out of Washington shouldn't matter. All I should be focusing on is the fact that there are strong, very strong forces at work that will ultimately drive the relationship between the dollar and the yen back towards equilibrium.

Q: Jeff, you started to talk about your new heuristic for trading the yen, and you mentioned it relates to the underlying volatility, which I assume means you want to be able to realize what the noise level is in relationship to the underlying fundamentals of the market. Could you talk a little bit more about the distinction that you make in your own mind between the noise and the signal of any trade? Because it seems to me that that is what keeps most people from getting the results that they want in the market.

Jeff: We're really back to this subject of leverage. In futures contracts, the margin is not really margin per se as in securities, in fact it's a performance bond, to guarantee that you're going to be there tomorrow. There is an incredible amount of leverage. Stock options have volatility in statistical terms somewhere between 30 percent and 50 percent per annum. But the volatility on various futures contracts can be as low as 7 percent.

It's this measure of volatility that determines margin. Margins are related to the expected daily change in prices. So what you need to do as part of a disciplined money management strategy is not employ your resources in such a way that the day-to-day fluctuations—what I consider to be noise—cause you to make an emotional decision as a result of your money being dissipated. Rather, you must be able to sit through the noise to acquire the benefit of the signal.

Q: How do you approach the whole question of money management? Is it something that you work out as a formula or is it a question of something that you do intuitively, that feels right?

Jeff: I think I always want the risk to be related to the amount of capital I have committed at any given time to the marketplace. And that risk should be no more than 1/7 of the amount of money that I have committed.

It turns out that there are transactions that I do that I call hurt-me transactions. They are risk-reducing in the sense that they play a part in the overall portfolio but they don't give you any credit on your performance bond. For example, a few weeks ago I was fairly bullish on the cattle market, thinking prices were going higher. It occurred to me that one of the reasons why I thought the cattle market was going higher was the fact that energy prices—gasoline in particular—was very cheap.

People had refinanced their home mortgages over the last 12 months resulting in a lot more disposable income. Even though there was a great supply, I always look three months out and in this case I didn't see that glut continuing. It occurred to me also that gasoline puts were an attractive sale, because if gasoline went down, there would be even more money to spend for food, barbecue parties, and the like. So I sold a quantity of gasoline puts as a kind of a hedge against the overall portfolio.

Q: Is there any reason why you sold puts rather than bought calls?

Jeff: It was a hurt-me trade, as I described it before.

Q: What does that mean exactly?

Jeff: The June gasoline futures were trading at 47 cents. And the 46 puts were at $2. For me to lose money being short the 46 puts, the gasoline market would have to go down three cents. And if the gasoline market went down three cents, that would be a very favorable event I thought towards my live cattle position. So I was willing to put this trade on, saying to myself, hey go ahead, hurt me!

I wasn't really looking to make money on this part of the trade. If the gasoline position went against me, the cattle position would go for me. So it was, "Make me feel good, hurt me!" You see this is what I do that I think is so different from what most traders do. I try to figure out risk-reducing positions that may not lower my overall performance bond, but lower the overall riskiness of the portfolio as long as I can handle the short-term noise.

Q: And allows you to think like the 10,000-lot trader?

Jeff: Right. There's another part to that whole transaction. We'd just gone through the end of the first quarter, and everybody was expecting oil prices to go down and I'm reading brokerage recommendations saying that oil prices are going to go lower in the second quarter because there is going to be more production of oil. I'm saying to myself here, we went through a huge sell-off and everybody expects there to be a glut in the second quarter. I can't see how this is going to happen! The people who had to sell have sold. Then an article appears in *Forbes* magazine listing commodities that are below their cost of production. And it was estimated that oil, which was trading near $15 a barrel which was well below the estimated $20 cost of production. I just saw little or no downside in that transaction given the environment that I was in and sure enough, as luck would have it, gasoline prices went from 47 to the high 49s. I don't know where they are today. (He checks his quotation) June gas is 5078 today and it was at 47 cents when I sold the 46 puts! So as you can see, I made a fair amount of money on that transaction.

Q: What happened on the cattle side?

Jeff: Well the cattle position changed. Over the intervening period, I switched from having a fairly long position to going short. It broke down to my price and I covered and have re-entered long again. So I probably now need to have more positive exposure to oil to protect my cattle position. As I mentioned, the position has changed a couple of times here.

Q: In contrast to your success, why do you think success is so elusive for most traders?

Jeff: I would say that the key thing people do that causes them to lose money is to have too big a position relative to their money. I think the second thing is people probably pay too little attention to acquiring an even disposition. They spend too little time studying the investment thinking of the masters before getting into the game. And they spend too much time searching out the opinions of other people and other analysts rather than being an investment detective. If you're going to be successful as a futures trader, you have to think of yourself as an investment Sherlock Holmes.

Q: Sherlock Holmes of the futures market.

Jeff: Yes. That's right. If it's obvious, it's not true. In fact on a recent trip I made to Boca Raton for the Futures Industry Association, I was talking to this journalist who served in the Navy. He had an aphorism that he told me and, as you know, I collect these things.

Q: Kernels of truth.

Jeff: Right. Silverman's kernels of truth.

Q: That's what I call you, Jeff, the colonel of truth!

Jeff: So this guy's aphorism was, "Nothing is true until it has been officially denied." And I thought about that for a while and my mind operates as this giant file system and I'm thinking about it. . . . Okay, let's think back to everything I can remember with respect to the government's confirming or denying some report. I remember most lucidly the events surrounding the Mexican peso devaluation. I forgot what year that might have been, maybe it was 1976. But the Minister of Finance of Mexico and the President of Mexico announced on a Thursday before the Labor Day weekend that there was no way in the world they would ever devalue. Over the weekend they devalued. Time and time again . . .

Q: Same thing with sterling last year.

Jeff: Absolutely. Every time a government says, "We will never, ever devalue," and it's written in print . . .

Q: Assume that they're going to devalue.

Jeff: That currency will be abandoned.

Q: It's like Nixon saying he's not a crook.

Jeff: That's a good example. Be careful; don't print that! Speaking of Nixon, I'm currently reading this book about the concept of politics. It starts with an analysis of the ideas of Plato and Aristotle and rapidly moves forward and literally touches upon almost everything. In one section the author is describing Nixon as the first political realist since Teddy Roosevelt and how, at the opposite end of the political pole, is Woodrow Wilson who was the most liberal, the one who most believed in human kindness, a mother's milk kind of guy. So whose portrait does Nixon the realist have hanging in his cabinet room? Woodrow Wilson!

Now I'm thinking to myself. Here's my trader's mentality coming into the picture. Is this because Woodrow Wilson is his idol or is this because he wants everyone to think Woodrow Wilson is his idol!

Q: Maybe he wanted to be reminded to never make the mistakes of Woodrow Wilson!

Jeff: I don't know, but I remember a few years ago driving with my family to visit the Eisenhower Library in Kansas. As you walk into the library museum the first thing you see are pictures of America's interstate highway system and the St. Lawrence seaway. And I thought about that one for a while, and I thought it makes sense! He was a soldier and a general. Here's a guy who directed 80-day mule teams across the country on rickety roads and he must have said to himself that if this country is going to be a world-class power, we need to be able to transport troops from one side of the country to the other to meet whatever challenges are at our borders. So he built a highway system to do that. Without that highway system, life as we know it would not be the same. A trader has to critically analyze the market the same way.

Q: So let me ask you a question, Jeffrey, as it relates to your trading, who's your Woodrow Wilson?

Jeff: I would say that the oracle from Omaha, as he is referred to, Warren Buffett. As you know I grew up in Omaha. Maybe there is something in the water out there that grows traders and speculators. I've read with relish all the things that he's written in the annual reports that he publishes. All the issues that surround being an investor that he discusses. I also gobbled up all the practical writings of professional traders, and I am a sucker for an investment book that relates to understanding the mind of other successful individuals. It all gets back to what my father-in-law said: "Why waste time making all the mistakes?" Look around and figure out who the smartest people are and try to understand what they're thinking and doing. And a lot of what I do, as we've discussed here, is involved with being that investment sleuth, the Sherlock Holmes, and finding the kernels of truth about where the next surprise is going to come from. I try to find something that nobody else really sees that is likely to happen. I think I am perceptive and receptive to information that doesn't announce itself!

I was chatting with a friend of mine recently on this subject and I saw something. Because I think so far out ahead, I see a particular kind of crisis coming two, three years from now. And I start saying, my God we have a crisis here. And they look at me like I'm nuts. What are you talking about? Well if we don't do anything and these trends continue for the next couple of years, we are going to have a big problem. So I start to do a quick back-of-the-envelope type of analysis. Let me remind you a lot of things in this world have been done by entrepreneurs on the backs of envelopes. The compact computer was designed on the back of a napkin!

It's very interesting; there are attitudes that are part of being an entrepreneur that are natural, that lead you to having intuitive ideas and answers to problems. . . . ways of thinking that don't occur to people that have a law background, for instance, which is based on precedent, or an accounting background, which is based and focused on facts, or even an economics background, which is based on statistics. We are back to my background and orientation as a trader. I'm always forcing myself to ask, "What are the pragmatic issues at work here? What do I see as the major factors coming out of this analysis that are going to drive the whole thing? What are the important variables that will make it all happen?" There is noise to deal with. The statistics themselves are noise. Within each of the statistics, there are random noise elements, but if you know what to look for there is a signal!

Q: So basically what you're saying is knowing the signal allows you to resolve the contradictory and conflicting information coming into the market at all times. Is that correct?

Jeff: What it really boils down to is belief in yourself and belief in the trade that you put on because you've done your analysis. Which also means you're going to ignore the noise, unless the noise reaches such a painful level to your financial being that there's obviously something that you're missing.

I remember I was involved with the start-up of Commodities Corp. some years ago. They raised $2.5 million through Hayden Stone, one of Shearson's predecessors in trading futures. They had a number of academics involved and one was my finance professor at MIT, Paul Cootner, one of the great minds in finance. Another was my economics teacher, the Nobel Laureate Paul Samuelson. There were several other Ph.D.s who had written about the nature and character of the markets. A gigantic debate raged within our organization. All the Ph.D.s argued that a system developed by a trader who was on staff at Commodities Corp. at the time couldn't work because it was a very simple moving-average trading system. As I recall the debate, Samuelson was saying that there was no way this could be profitable. It was his opinion that in the long run all these trend-following systems cannot possibly work because the markets are efficient. I remember Cootner saying, and by the way he was the editor of the book, *The Random Walk Character of Stock Market Prices,* that futures prices resemble a random walk. However, Cootner was also very pragmatic. He said, "If it works let's do it. And when it stops working let's abandon it!"

There are periods of time where the market does in fact trend and other times when it detrends and goes up and down and chops the trend followers apart until they can't stand it any more and forces them to give up their process until the market again proceeds to trend. I don't know that any particular systems can make someone money. Any kind of a system will work, whether it's a purely fundamental system or a very eclectic one such as mine. Or a technical system involving charting and computers. They all work. The key point is all these systems require a degree of discipline, a degree of being in tune with oneself. What is absolutely essential is knowledge of oneself and willingness to stick to whatever the plan is. And thoughtful sleuthing! You can't learn that by buying a trading program or learning someone else's technical strategy.

Q: So what is the answer?

Jeff: Becoming a successful trader involves possessing a state of mind where you are open to all sorts of information. You're researching trades in nonobvious places. Who would think that I could come to the conclusion that the yen is no good by driving a rented Thunderbird in Florida? As Peter Lynch would say, the answers are all around us. We see the economy getting stronger and stronger. This offers all kinds of scenarios and opportunities. Remember the most interesting and profitable opportunities occur when conventional wisdom is set the other way.

If I can make just one point, which I think is essential. What I do is very simple—I am searching for what is practical, what works. I am not searching out the perfect system. I am searching out truth in supply and demand. You know there is always joy in being uniquely right doing something that looks absolutely absurd and crazy on the surface.

Q: Sounds like the rewards justify the risk.

Jeff: And the rewards justify the risk because this is where the whole issue of fading the conventional wisdom is. If you're wrong fading the conventional wisdom, you lose a little. If you're right fading the conventional wisdom, you make a lot, an awful lot! You know, the conventional wisdom as Soros and his crowd were beating down the yen, was that the yen was going down. They beat the market from 95 cents to 89, 87 in that area. And then it blew up in their faces. It went back to where they started. The explosive rally happened because they were all there and they were all pushing. The trades that have the good risk/reward ratios are the ones that nobody believes in precisely because they are priced attractively.

In other words, what we are talking about here is a very sensible, very disciplined approach toward contrary opinion investing. Where one uses all of one's senses to try to model what is going on in the minds of all the people involved in the market or all those who are utilizing that commodity, that currency, that interest-rate product. Because unless you have internalized something that is different and better than what the other competitors in this game have as their set of tools, you can't make money. You must have an edge and bring something special to the table. Something out of the ordinary. And what I will argue is what Peter Lynch of the Magellan Fund will argue and what Warren Buffet will argue. It's that little special sensitivity for the kernels of truth that are out there lying on the ground. They're waiting and all you have to do is pick them up.

Q: Buy low, sell high.

Jeff: Yeah. And wear diamonds!

Chapter Nine

Donald Sliter

Donald Sliter began his association with the futures industry in 1978, as a runner for Ray E. Friedman & Co. In 1981 he began working for Shatkin Trading Co., where he clerked for many of the firm's top traders. Mr. Sliter began trading for his own account in 1984 at the Chicago Board of Trade. Since 1986 he has been a floor trader in the S&P 500 stock index contract. He is a member of the Index and Options Market of the Chicago Mercantile Exchange.

Q: Don, what first attracted you to trading?

Don: I got a job at the Board of Trade by pure chance. I was unemployed, out of school, and a friend of mine was working on the floor as a runner. He said, "Come on down." I got hooked the moment I saw it! This was 1978.

I've always been a stickler for numbers. Love numbers. Very quick with numbers. Trading just seemed like the game I wanted to play. I've played sports all my life, and if you notice in the pits, there are a lot of former athletes who are just naturally attracted to trading. I started as a runner and after a while became an outtrade clerk. Then I went to work for a local firm, Shatkin (Pat Arbor and Henry Shatkin). I started working for a bunch of big-time locals. This was in the 1980s bean market, and it just clicked!

Q: When you say clicked, what do you mean?

Don: I knew trading was something I could be good at. It's a numbers game. And like I said, I'm really good with numbers. For some reason, I've always had that ability. It was something I wanted to do.

Q: You could feel that right away?

Don: Right. I could tell it was a business that breeds success if you're good. In my head, I always knew I'd be successful. I have no idea why. So when things clicked for me on the floor I just said to myself, "I'll be successful, just like I was in baseball."

Q: You were a baseball player?

Don: Right. I was a good baseball player. When I was growing up, I planned on being a professional. It didn't pan out because I hurt my arm. I was in the doldrums for a while. But I just knew I'd be really successful at something. You see all my life I've always been a hard worker, and I always believed that if you work hard at something, you put in your time, it's going to work for you!

Q: What do you enjoy most about your trading?

Don: It's different every single day. Every situation is different. You don't sit there and push a pen. It's like playing sports. It's *mano a mano*.

Q: Well, it's obvious that you love the competition.

Don: Oh. . . .

Q: I mean, I'm just looking at your face, and the readers won't be able to see this, but you get so intense talking about going against the competition.

Don: I get in the car in the morning, and I'm juiced. I can't wait, especially on number days or on expirations. I get so pumped up sometimes . . .

Q: What pumps you up?

Don: Just the idea that it's going to be different, that I'm in control of my own situation, my own destiny, every single day. There's nobody to answer to. Everything you do, you're either rewarded or you're spanked for.

Q: Well, you know, it's real interesting that you put it that way, because it's just the opposite for most traders. They trade and feel like they're out of control, that there are so many forces going on around them all the time, taking away the control. What do you think?

Don: I think that's a lack of discipline. To me, if you're disciplined, you're always in control.

Q: What do you think is your greatest strength as a trader?

Don: Discipline. Being disciplined and having speed. I don't mean to boast, but I am the fastest. I can turn a card faster than anybody on the trading floor.

Q: You think you're the fastest trader in the S&Ps?

Don: Right. If I'm wrong, I will get out, boom. Say I'm long, 100 contracts boom. I'm out. I'll get every bit until I get short, and then I'll reverse. That's my key. I like to reverse. I don't like to just get out. I like to reverse and go the other way.

Q: So if you feel you're in a bad position, not only will you bail out of your position, you'll go the opposite way.

Don: Right. And I will do it faster than anybody else. I especially like it if I've got a bunch of locals who are the other way and you just take them and make sure you get every bit so they have no way out.

Q: Right.

Don: It's really not that cruel because in reality, as you know, trading is just you.

Q: Right. Now I think most people have this idea that if you're talking to one of the most successful guys in the S&P pit, well, he must have been a natural. He must have just walked in and from the first minute he started trading he found pure success. Could you kind of run us through what your history has been like.

Don: I blew out in 1984!

Q: You actually started trading in that year. Is that right?

Don: I started trading in 1984, and I blew out in the first year.

Q: What were you trading?

Don: Beans. And then I switched over to the maxi pit [Blue Chip Index].

Q: When you were trading the beans, were you scalping the market or spreading it?

Don: Scalping it. I've always been a guy who likes the straight-out action. My second week in the beans I did three million a side. I just liked it, you know?

Q: And you talk about discipline!

Don: That's what I'm saying. That's why I blew out. It was like, well, I've got, you know, the edge.

Q: Oh, you felt at that point that having three million beans on gave you the edge?

Don: No. No. I did three million a side.

Q: Right.

Don: No. You just think well, you know, if they're going to give it to me, they're going to give me the edge, not knowing that the edge is not always the edge!

Q: Exactly.

Don: You do have a responsibility.

Q: To yourself and to your family, right?

Don: Right. Well, I didn't have a family back then. I was married, but my wife worked down at the Board, too.

Q: Okay, so you had a rough time in the beginning, you overtraded and blew out. How long were you out of the business?

Don: Oh, I just went back to work.

Q: You went back to work?

Don: Look, I'm an incredibly hard worker. I worked in the clearinghouse for six years. I knew the ins and outs of the back office very well. When I first started, you know, I started as a runner. I built myself up. I was putting in five-day weeks, at least 70 hours a week.

Q: Wow.

Q: Oh yeah. I was running the back office.

Q: Right.

Don: We had over 300 locals. Something like that, whatever it was! That doesn't make a difference. The point is I've got an incredible work ethic. It's basic. Hank Shatkin was kind enough to let me go back to work. So I built up my capital again and went back into the pit, but I had another hard time.

Q: Another bad experience?

Don: Right, lack of discipline again!

Q: Also in the bean pit?

Don: In the maxis. This was about 1985; 1986 I had a hard time, too.

Q: How did you keep yourself going at that point?

Don: Well, like I said, I was still working with Shatkin.

Q: No, no. I don't mean that, I mean psychologically; you said you always felt like you were going to be successful and now you have two larger-than-life instances where you've blown out. I mean, are you still saying to yourself, you're going to be successful at this?

Don: Yeah, sure! I still felt that. But I began to blame it on other things. You know, when you're not thinking in the right frame of mind all you can see are these outside factors that are really messing you up. It's a lie.

Q: Right.

Don: It's a bunch of crap. Can I say crap?

Q: Yeah.

Don: I had a hard time, and then I met up with a friend of mine, Bruce Williams. He is a very good trader. He told me things that completely turned my trading around. You hit singles every day and you don't go for the home run. You chip away, chip away. By the end of the day, you've got a good day going. A lot of chips!

Q: Now in the beginning, you were looking for the home runs every time, right?

Don: Oh, God! My first week in the maxis, I had over 225 cars on. This is no bull, some days I'd do 10-15 percent of the volume. One day we calculated I personally did 22 percent of the trading volume but I was getting killed.

Q: And at that point, when you were sitting with a 225-car maxi position, that's like five or six hundred S&Ps. I think that's a large position for anyone's first week!

Don: You have no idea. I had people getting me out. I was running back and forth. I was spreading with the bonds. That's why I blew out, no discipline! My wife called it self-destruction. She said, you self-destruct every time that you get up and start to do well.

Q: Did you think about that while you were doing it?

Don: I had no idea what I was doing then. But I realized I had to work on myself, to straighten out my personal game plan. I moved from the Board to the CME. I left all the bad associations behind. . . . At the Board, people weren't trading with me, because I was just a wild man!

Q: When you say, Don, you were a wild man, you mean, you were just willing to do any size?

Don: Any size. I would do anything.

Q: Right.

Don: You know . . . just to trade.

Q: Trading was kind of like cocaine. I mean it seems you just needed it. You just . . .

Don: It was a drug. You're right. Basically it was a drug. In November of 1986 I came over to the Merc. I was busted. I had zip. As I started to say, my friend Bruce bailed me out. He lent me $30,000 to get back in. He cautioned me to take it easy. He told me, "You'll do okay, you're a good trader." He had a lot of confidence in me.

Q: Were you discouraged at this point?

Don: I was getting very discouraged. Bruce showed a lot of confidence in me. I guess he saw something. . . .

Q: He was obviously right.

Don: He literally bailed me out. That was November of 1986. Would you believe I have not a had a losing month since! It's been 100 months straight. And in between, maybe, I've had a handful of losing weeks. Maybe! You see I just started trading within my means. Each day, I would just chip away. I made a little bit here. I started building up my pockets. Then in 1990, there was the war and the S&Ps got real busy. You know, you're chipping away becomes. . . . big! What you used to think was a home run, that is just a small chip today.

It has gotten to the point that they're not chips anymore, but I still view it as chipping away in a sense. To other people, the numbers are awesome. I've watched the guys who hit the home runs, and you know it's just not my style anymore. I don't like putting all my eggs in one basket. I don't believe in that.

Q: What are your trading goals?

Don: One of my goals is to stay disciplined. Another is not to allow myself to get lazy. My goal is to trade everyday. It's my job. I consider myself a blue collar worker with a white collar income. I still have to go in there and grind it away everyday. That's my main goal, really.

Q: What would you say is your strategy when you're trading in the pit?

Don: Understanding strength and weakness. It's very basic. I stick with it, and it works.

Q: How do you understand strength and weakness?

Don: I scalp to the short side if we're trading weak to the Dow. I scalp to the long side if we're trading strong to the Dow.

Q: That's it?

Don: Yes, it's basically the way the programs [program trading] work anyway. You can watch it and see for yourself.

Q: That's all you're doing? Buying hundreds of S&Ps, if they're stronger than the Dow and vice versa?

Don: Right.

Q: And you'll sell the S&Ps if the futures are weak to the Dow?

Don: Yes, I'll initiate my scalps that way. I'll also watch to see what the pit is doing. It has been my experience that when the S&Ps are trading weak to the Dow, you'll always have an offer above the market where you can get out. Some days, my strategy is just to play the locals. If the market stays within a tight range I watch them play for the breakout, and if it gets higher, I sell it. If it gets lower, I buy it.

Q: Do you have points that you use to enter or exit the market?

Don: That's one of my gifts; like I said before, I've always been good with numbers. I have very good recall. I can remember important numbers from 1986. I also have a pretty good sense of where the significant numbers are, based on where the market tops out or bottoms.

Q: So how do you initiate your trades? What strategy do you use?

Don: I watch the paper [order flow]. The paper is smarter than I am usually. So I watch what it's doing. You know that they're keying off something so that's important to watch.

Q: And you'll fade the paper?

Don: I used to try to go with them, but they have more staying power than I do.

Q: When you're selling at a price and you may do three to four thousand round turns in a day, what are you looking for in the trade? What are you saying to yourself? Are you scalping for a set amount of points?

Don: Well, if I sell evens, I will be bidding 80. I mean, if it's 80 bid, I'll just keep bidding 80. And if I get hit on 80s, and I feel it's going to go, I'll dump the 80s. I'll buy 70s. You know, I'll be in and out. It won't be a straight position. I'll be short 80 or 85 cars, let's say, which I was this morning, and I'll be buying them out, but I'll also put them back out a little later, and you just keep offering. And if you're getting hit, you might have the same position all the way down, but you've got scalps in between. For example, today it all happened in a market with a 130-point trading range.

The point is I'm constantly in the stream of what's going on in the market flow. I mean, I have my bias but I'm constantly scalping with the market direction.

Q: Why do you think so many traders have problems with their trading?

Don: Fear. Greed. Lack of discipline. I don't fear the market. I respect it, but I definitely don't fear it! You know, the market's going to do what the market's going to do, regardless of what I do. But most people get this thing in their head. The market's going down. The market's going up. You know, like that. They're trying to get the market to do what they feel, what's in their head.

As far as I'm concerned, the hardest thing in trading is pulling the trigger. Initiating the trade. You spoke about it in *The Innergame of Trading.* I used to feel that way too. But no more.

Q: When you were going through that difficult period and when you were coming back, did you feel insecure about initiating trades?

Don: I did, but I forced myself to still bid and offer. That was part of the discipline.

Q: So you've always felt like you've had the nerve to play the market?

Don: Oh sure. That's the biggest thing when it comes to pulling the trigger. Just to do the trade, to get the confidence to keep doing it. When I'm trading I'm in a zone. You know, other than trading, I have no idea what's going on. I rarely even look up at the Exchange clock or boards or anything. All I do is trade every tick. I hand my clerk cards one after another. He's got a stack of cards three inches high and I don't even have names on them. Many times I don't even know what handle we're trading.

Q: He has to reconstruct your trades?

Don: Yeah, and he's got a hard job! His name is Robert Licoco. He's got a very hard job but he's good at it. He gets the job done . . .

Q: Don, what do you believe about yourself as a trader?

Don: I know I'm very upbeat. Each day I just remind myself that I couldn't go anywhere else and make the kind of money I do. I believe, as I said before, I'm the fastest trader in the pit. Hey, I don't mean to boast . . . .

Q: Right. That's okay. What else?

Don: I certainly don't believe I'm smarter than everybody else by any means. But I do believe that I'm probably the most disciplined trader on the floor for scalping the size that I do. I've really worked at being able to do that. It took a lot of years and a lot of pain to get here.

Q: You know, Don, I've watched you trade on any number of occasions in the pit and visually your trading really stands out. I'm impressed by how much you seem to be enjoying yourself when you're scalping the market.

Don: What's there not to enjoy?

Q: It's like someone's tickling you the way you trade.

Don: Yeah, they're tickling my fancy!

Q: I mean, is that true? Are you always that positive?

Don: I love trading, you have to understand that. I'm going to be very upset when they start to computerize . . . and it's going to happen. I'll probably retire. I mean they're already going to these hand-held things. I don't know how I'm going to handle that.

Q: What is it that you love so much? Is it the man-to-man competition?

Don: Sure. It's fun, because I've got a reputation now and everybody looks at me. I also really try to work with brokers. As a group, they're pretty fair. There is one guy, however, who bids and offers a block of 125 contracts. He usually has 500, and he'll try to sandbag you if he can. You learn to stay away from those guys. When he buys 50 or 100 cars from me, I know that he's working another 400 cars. I'll get out. I won't even mess with him.

Q: You know he's setting you up?

Don: He used to set me up with 50, then 70, then another 100. Finally one day I said, "Look, you can't do that to me all the time. I mean, I know you're taught to do this, but I'm a fair guy. Don't sit there and buy 50 and 100 cars from me and then race me all the way up to get the rest of your 500 contract order. I don't think that's the right way to work with the locals. I mean, hey, it's a two-sided street."

Q: Right, and it's not a particularly professional way to fill orders.

Don: No, it's not. You asked about beliefs. I believe I handle myself very professionally, and I've always prided myself on that. I don't want anybody sticking it to me and I would observe the same courtesy with them.

Q: Does that get you angry when that happens?

Don: Yeah, it gets me very angry!

Q: Does it affect your trading when you get angry?

Don: I don't let anger get to me because I know it will affect my trading. It'll affect anybody's trading.

Q: In *The Innergame of Trading,* we write about the importance of keeping a resourceful state of mind, and obviously it's hard to do that when you're pissed off. In general, how do you keep yourself fresh and strong and upbeat?

Don: I keep myself in great shape. I get a lot of sleep and I wake up each day at the same time. I come in and I trade for two hours, 8:30 to 10:30 a.m. Then I go play basketball in the middle of the day... every single day from 11:00 to 1:00.

Q: When all the other guys are in the pit . . .

Don: And beating their brains out! You know, I've tried to invite two or three guys I really like to come and play ball with me and they say, "No way, we've gotta stay!" You see, I strongly believe there's a point of negative return. For the one day that something big happens, there are nine days that nothing's going on.

Q: So when New York is out on lunch . . .

Don: I'm shooting hoops! When Chicago's out to lunch I'm still playing basketball. I come back at 1:30 and I look all around at the guys in the pit. Their eyes are all down to their navels. They look like, Oh my God, get me out of here! They're looking at the clock waiting to get out and there are two more long hours to go!

Q: And you're fresh.

Don: I'm feeling great. I'm saying to myself, let's play.

Q: So for you, trading is really like playing basketball. I would like to convey to our readers that even as we're just talking about your trading you are incredibly animated. You are almost jumping out of your seat. You're having such a good time, just talking about it! I get the feeling that trading is just a huge high for you.

Don: I'll tell you what: I get in a zone. I'll trade thousands of S&P contracts in a day and I'm just moving in and moving out, feeling great eating up everything in sight.

Q: You're like a hungry lion waiting for dinner.

Don: I'm standing in the pit and I'm scalping 50, 70. I'm giving bids and offers. I'm just scalping back and forth. I have no idea what my count is, because the market is moving in a tight range. It trades in a 50, 75 point range. And, you know, I can usually rely on the fact that I'm going to be able to get in and out, because there's a two-sided, 50-lot edge everywhere. I just get into this zone and I'm just feeling great. I'm handing my clerk cards with no names on them. I have no idea what's going on, what my count is. Except the register is ringing and I'm chipping away!

Q: You said in an expiration month you might do 1,000 S&P contracts within one time bracket. Is that possible?

Don: Last February during expiration, I did 4,400 S&P contracts.

Q: What's an average day for you?

Don: A couple of thousand contracts on a normal trading day.

Q: Isn't it hard to trade that much?

Don: I keep telling you it's unconscious, I get in the zone. I swear to God, it's better than sex! It is! After the trade, Robert hands me my cards, my dupes. I look them over to see how I did. I would do it even if I lost money, because it's just a gas!

Q: But usually you don't.

Don: I never do on the expiration . . .

Q: And that adds to the fun, right?

Don: Oh, sure. I mean, I can't say I would do it for nothing.

Q: Right, Don, I completely understand.

Don: But in the expirations, I'd consider doing it for nothing just to have that juice in my veins. You know? It's fun!

Q: So it's fair to say that since 1986, since your arrival on the shores of the Chicago Mercantile Exchange, you've done okay.

Don: I've done very well. I came in 1986; 1987 was the crash, but, in truth, I didn't capitalize on it. I was trading hesitantly, a little bit here, a little bit there. The year 1988 was very slow, very slow, because of the post-crash trade. In 1989 things started to pick up. I did pretty well in 1989; 1990 we had the war, and I really cleaned up. Since then, it's all been real good. Believe me, I have no complaints!

Q: I want to focus again on your trading strategy. As you know, most successful trading strategy is simple. It is not that it's easy but it can be employed simply, with absolute certainty. As you mentioned earlier, when you determine the Dow is weak, then you're a seller of the S&P and you keep scalping from the short side until the market proves otherwise.

Don: I usually finish the day this way too, which sets up a nice close for me.

Q: In other words, you're looking to sell the close when the Dow is weak.

Don: Oh, sure. If the Dow stocks are weak, about 80 percent of the time . . . you can scalp that close for 30 or 40 cents from the short side.

Q: Will you be selling it into the close or do you wait for the closing range?

Don: I probably will be selling a little bit into the close. I really think that once the closing range starts, if you're moving size it's hard to get out. So I'd rather be in a little bit already and take my risk that way.

Q: Don, did you have any role models?

Don: Bruce Williams. He is the guy who bailed me out. He is a tremendous trader.

Q: What was it that you saw in him?

Don: Total confidence. The most confident person I've ever met in my life. When he was scalping, he was brilliant. He'd just play the locals against each other. He'd know how to work with the paper. He did all the things I try to do; however, he's a little bit more long term. He was absolutely confident and never feared the market.

Q: What does that mean, "Absolute confidence?"

Don: I initiate every trade feeling it's going to be a winner. Of course I know every trade can't be a winner but it's that confidence that keeps me fresh and in the game. When I'm wrong, I get right out. Then it's on to the next winner!

The thing that I've tried to do consistently, like I said before, is not put all my eggs in one basket. Even on days when I'm getting beat up, I just know I can get it back. That is why my strategy is just to keep chipping away. Not like I did in the early 1980s, hit a home run and then just give it away in one day. That's just ridiculous. That's stupid.

The discipline is to go back to money management and evaluate the risk/reward trade-off. I always want to know that I can make more in a trade than I'm going to lose. It is that discipline with the size that I trade that makes my trading strategy, I think, unique.

Q: Any other role models?

Don: Steve Lawrence in the bonds. I used to work for him. He started in 1981. After he made a ton of money trading he was still working his night job at a grocery store because he still wasn't sure he'd make it as a trader. By 1984, I watched him cap out [reach his annual commission rate cut off] in a day and a half. His clearing firm had to reimburse him starting from the second day of the year. He traded 20,000 bond contracts on his first day, and 20,000 the next. He was a tremendous scalper. Now, I think he does more position trading, though. I mean, he just loads up.

Q: Do you think your strategy is similar?

Don: Not anymore because, like I said, I'm incredibly disciplined. I'm always ready to move on a dime if I'm wrong. I don't load up on hope anymore. What I feel I learned from Steve was learning how to get in that zone.

There is someone else but I can't use his name. He was in the beans when the beans were in a huge market. It was the 1983 market. He was a monster trader. I would ask him how he was doing, and he would reply, "I think I made about $470,000." He was just scalping. He didn't take positions! He was just getting in and out, bidding and offering, moving those beans on and off his cards. And that impressed me!

Q: Do you like to leave at the end of the day without a position on?

Don: Most of the time. Occasionally I will go home with a few contracts on in case I'm out something [as protection against outtrades]. It usually blows up in my face, though.

Q: I know an S&P trader, a well-known trader who might trade 700-800 contracts in a day. He is an off-the-floor scalper. But he feels uncomfortable if he goes home with more than a five lot.

Don: I have a friend in the pit I want to tell you about. He stands right next to me. He'll scalp Globex for 50 lots overnight, but he will never do 50 contracts in the pit. I asked him, "What is wrong with you?" He said, "I watch you. You have hundreds of cars on, and you know, you're all juiced up and you're having a good time, but you don't feel comfortable taking a 20-lot home. I do 50, 60, 70 cars from home, but am paranoid with 40 cars in the pit!" I said, "That doesn't make any sense. You have no control!" He looked at me and laughed. He said, "I have control. You don't have control!"

Q: But you know what, I think what is very interesting is that control is how we see it.

Don: Yeah, I guess.

Q: Yeah. It's all a matter of what you see, hear, and feel in the market. I mean, you feel like you're enormously disciplined and it appears that you are. Considering the numbers that you do, three or four thousand S&Ps a side, most people would think, hey, a guy who's doing those numbers is out of control!

Don: I would like to say one thing. I'd really like to influence the public's perception of this business. Everybody's not a gunslinger. I'm not a gunslinger. I trade size, but I'm incredibly careful about what I do. I think that if you go in there and put your time in, and exercise rigid discipline every day, you can do it.

Q: So it seems to me, if I were to sum up your trading strategy, it is this: You always take a small loss when you're wrong. You try to take as much profit as you can pull out of the market when you are right, based on your perception of market strength. And you focus on the psychology of the pit traders who are around you.

Don: No matter what the trade is I always try to finish it off as a winner. If I buy 50 cars, 160, whatever, even if I'm wrong; on my next trade, I immediately try to make just one or two ticks on a 10 lot. That makes me feel 100 percent better on the trade. I finish the trade off as a winner. I find for me that works well. You go into the next trade feeling good . . . feeling better.

Q: Feeling confident.

Don: Sure.

Q: I think you've pointed out very well the importance of state of mind. You have, in fact, figured out a way for yourself to leave that trade feeling positive even when it goes against you . . .

Don: It's gone.

Q: . . . with a good state of mind!

Don: Have you ever watched most traders? You go in the break room, and every trade has a story! Every single trade! Yeah, you know, I did this, and the market went against me. Bullshit! I don't do that. If I did that, I would be telling stories for the next week.

Q: It's like each trade is a small novel filled with plots and characters!

Don: Sure. It's Agatha Christie at its best. How the market got you!

Q: That's your great strength . . .You just do it. You're in the zone.

Don: You have to be, in my opinion.

Q: What words of advice would you give to an aspiring trader or someone who's encountered some difficulty in trading right now that really wants to be successful?

Don: I would say, don't trade beyond your means. Your financial means and your psychological means. Make sure that the risk rewards tilts to your edge, to your end, always. Be disciplined and don't load up. Just try to keep chipping away. Keep trying to hit the singles.

Q: And enjoy yourself, right?

Don: Enjoy it! It's a game! I've always thought it's a game, but everybody's going to say, well, he's got money and this is why. But believe me, I've always thought of it that way.

Q: In my trading seminars I always say make a commitment to enjoy yourself. Be committed to having a good time.

Don: That's right!

Q: You're living proof of that.

Don: It's fun! Where else can you do this! This is Thunder Dome and I'm Mad Max!

Q: Without Tina Turner.

Don: That's right, but I'm still having a hell of a good time!

PART IV
WINNING VS. LOSING

Chapter Ten

Capturing the Real Edge

We began *The Outer Game of Trading* with a discussion of the personal characteristics of successful traders; the more deeply we probe the question of effective trading strategies, the more we keep coming back to the whole question of personal qualities and values. In *The Alchemy of Finance*, (New York: Wiley, 1994), George Soros writes:

> "Values are closely associated with the concept of self—a reflexive concept if ever there was one. What we think has a much greater bearing on what we are than the world around us. What we are cannot possibly correspond to what we think we are, but there is a two-way interplay between the two concepts. As we make our way in the world our sense of self evolves. The relationship between what we think we are and what we are in reality is the key to happiness—in other words, it provides the subjective meaning of life."

An old Chicago Mercantile Exchange advertisement reads:

"Was Toulouse-Lautrec too short to trade commodities? No. Too temperamental. Lautrec was a highly emotional man given to impulsive changes of opinion. Such a personality is ill-suited to futures trading."

Capturing the real edge in trading involves the following:

- Personal discipline based on hard work, independence, and patience
- Love of trading—making the process fun
- Well defined risk management
- Total acceptance of losing as part of the process
- Understanding and acting on your motives for trading

Figure 10-1 Critical Factors in Determining the Edge That Makes the Difference

Trader Response	Having the Edge	Losing the Edge
Patience	Waits for opportunities to materialize based on well-thought out game plan	Little planning; reacts according to personal whim
Discipline	Sees the big picture, responds deliberately.	Emotional, anxious; often confused about what to do
Strategy	Highly planned; limits losses; lets profits run	Little planning, does not rely on consistent methodology
Expertise	Well prepared; has done the necessary homework	Little market knowledge; unprepared
Motive	Long-term motive, e.g., intellectual challenge	To make money; instant gratification
Goals	Clearly defined	Ill-defined
Risk Control	Highly controlled risk/reward ratio	Little or no control over risk/reward ratio.
State of Mind	Positive, resourceful empowering beliefs and focus. High level of self-esteem and trust; relaxed and confident	Nervous, anxious; believes the worst will happen. Focus is distracted. Trades in conflict

- Developing a personal strategy that works for you and fits your personality
- Trading in a positive state of mind

If we were to lay out graphically what we have learned from the traders we interviewed, it would look like Figure 10-1.

It is just that simple, not easy but simple. Anything else is distraction.

The *Book of Five Rings* was written by Miyamoto Musashi in 1643. It is one of the most important texts on strategy emerging from Japan's Bushi (Samurai) culture. Its insights were designed for leaders in all professions who were in search of individual mastery and achieving personal excellence. Musashi advises the following:

"Think of what is right and true.
Learn to see everything accurately.
Become aware of what is not obvious.
Be careful even in small matters.
Do not do anything useless."

Fifty Reasons Why We/It/They Can't Change

1. We've never done it before.
2. Nobody else has ever done it.
3. It has never been tried before.
4. We tried it before.
5. Another company/person tried it before.
6. We've been doing it this way for 25 years.
7. It won't work in a small company.
8. It won't work in a large company.
9. It won't work in our company.
10. Why change—it's working okay.
11. The boss will never buy it.
12. It needs further investigation.
13. Our competitors are not doing it.
14. It's too much trouble to change.
15. Our company is different.
16. The ad department says it can't be sold.
17. Production says it's a bad idea.
18. The service department won't like it.
19. The janitor says it can't be done.
20. It can't be done.
21. We don't have the money.
22. We don't have the personnel.
23. We don't have the equipment.
24. The union will scream.
25. It's too visionary.
26. You can't teach an old dog new tricks.
27. It's too radical a change.
28. It's beyond my responsibility.
29. It's not my job.
30. We don't have the time.

Continued on next page

Fifty Reasons Why We/It/They Can't Change

31. It will make other procedures obsolete.
32. Customers won't buy it.
33. It's contrary to policy.
34. It will increase overhead.
35. The employees will never buy it.
36. It's not our problem.
37. I don't like it.
38. You're right, but . . . .
39. We're not ready for it.
40. It needs more thought.
41. Management won't accept it.
42. We can't take the chance.
43. We'd lose money on it.
44. It takes too long to pay out.
45. We're doing all right as it is.
46. It needs committee study.
47. Competition won't like it.
48. It needs sleeping on.
49. It won't work in this department.
50. It's impossible.

(Louis Boone, *Quotable Business*, New York: Random House, 1992)

Chapter Eleven

The Winning Skills of the Trader

> "There is much to being a successful trader. There are many rules to be applied and many lessons to be learned. There must be a willingness and ability to learn, to comprehend fundamentals and statistics, to grasp technical application, to develop an inner trading sense, to accept defeat and live with victory, and much more. But most of all, there must be present a multitude of inborn characteristics relating to the trader's personality, psychology, emotional equilibrium, courage and patience."
>
> *Leo Melamed*

There is an ancient Chinese proverb that states that before climbing a perilous summit, one must study all possible routes of access and escape and then "really" learn how to climb it from someone who has already made the journey. We have learned a great deal from our interviews with the top traders, how they think about markets in terms of developing successful strategies that work (the ultimate test) and what they believe about themselves and the market which allows them to apply their strategies effectively whether they trade futures, options or spreads, whether they are technicians or fundamentalists. Success resides finally in one's intensity and commitment to succeed.

Discipline

James Loehr, the eminent sports psychologist, writes in *The Mental Game* (New York: Viking Penguin, 1990), "Desire was consistently identified as the chief factor leading to competitive success." In addition, it has been our observation that, given the broad range of possible strategies, all of which can be successful, it is ultimately the inner game of the trader which assures the implementation and effectiveness of the outer game. In *Futures Trading Strategy* (Homewood, IL: Irwin, 1988), Stanley Knoll writes, "While a consistent viable strategy is clearly the mainstay of a successful operation, these additional traits are required: discipline, discipline and (you guessed it) discipline." We couldn't agree more!

When we asked Pat Arbor, chairman of the board of the Chicago Board of Trade, what is the essential characteristic required of a successful trader his answer was: "It all comes down to one thing, bottom line. It's discipline. Discipline is the way you handle yourself no matter what else is going on around you. Having it results in success. Lacking discipline and you're a loser."

Jack Sandner, chairman of the board of the Chicago Mercantile Exchange, answered our question in a similar way.

> "Discipline. I could elaborate on what that means; it means different things to different people. But I think one of the main ingredients is focus. They say traders have a nice life. They come in at 8:30 or whatever, and they're gone at 1:00. You see their expensive cars going down the expressway. What people don't realize is that a lot happens before the bell rings and a lot happens after the bell rings. The other thing people don't realize is between the opening and closing bell a tremendous energy is expended in focus, if you're any good at what you do. I don't know one trader that's any good that doesn't really focus 1,000 percent every second on what he's doing, and is consumed by it. And the traders that aren't good, they sojourn. They're lazy and they'll make money sometimes, but they'll get caught. I think it takes a tremendous attention span and focus of attention on exactly what you're doing. If you don't do that, then the discipline can't

follow. You can't be disciplined unless you focus, because it's too easy to look away and rationalize."

Focus

The key to discipline is focus, and you see you always have a broad range of choices at your disposal. It is your choice and ultimately your responsibility what you select as your object of attention.

It is your movie screen and the pictures you project (i.e., analysis, charts, strategies, options) are entirely yours. The top traders understand this and are conditioned to react and take action at their particular point of focus with decisiveness, without conflict or uncertainty. Their focus allows them to stay true to the top-performing recipe: Identify a signal, take automatic action, and feel good. The difficult part, of course, is maintaining a high level of focus without distraction or internal resistance. It is for this reason that having a well-defined strategy that contains all the necessary criteria for success is so vital.

> "It takes a man a long time to learn all the lessons of all his mistakes. They say there are two sides to everything. But there is only one side to the stock market; and it is not the bull side or the bear side, but the right side. It took me longer to get that general principle fixed firmly in my mind then it did most of the more technical phases of the game of stock speculation."
>
> *Edwin Lefevre*

It is our belief that elevating your state of mind continually by focusing on internal and external phenomena that allow you to stay resourceful and true to your trading strategy is the answer. We have demonstrated how to do this through processing positive beliefs and thoughts and by directing your physiology. When a negative thought comes into consciousness and begins to distract your focus, don't fight it. Acknowledge its existence and go forward.

In their book, *The Positive Force* (New York: NAL Dutton, 1992), Gary and Pat Emery make this point in a very interesting way. "Trying not to think a thought is like trying not to notice the phone is ringing. All you can think about is the phone ringing. Try to deny or fight a thought and you empower it. Your intellect reasons, 'My thought must be pretty serious. Why else would I fight it?' Your thought system concludes, "This call is too important to miss," and the thought keeps ringing through. Give yourself the opposite message. Acknowledge the thought, realize it's a wrong number and move on." When you experience negative self-talk while trading, always remember it's the voice of someone who hasn't considered you fairly, or be mindful of what Joseph Conrad wrote, "Words, as is well known, are the great foes of reality."

Optimism

There is one fact that all the top traders agree on: Successful trading, that is, the development and implementation of effective trading strategies, begins with an attitude of optimism. Bruce Johnson summed it up best when he said, "I always kind of say to myself that I'm going to have a good day. And even if it isn't good, I always kind of look on the bright side of everything. I'm really the eternal optimist, which I think is essential. I mean, that's like the essential ingredient in being a good trader; you just have to be positive. . . . You cannot place psychological pressure on yourself. If you do, you better be able to put it out of your mind. I think there are very few people who can do that. That's why there are so few really great traders."

Jack Sandner echoed this same sentiment when he said, "I always say this is the first day of the rest of my life, and I come in optimistic with the glass half full, and I'm able to do it even if that day turns out to be negative. I start the next day by telling myself today is the first day of the rest of my life and I'm going to keep the same air of optimism, the same physiology, the same way of thinking that I had before when I was successful. I'm going to do the same successful thing!"

Martin Seligman, the author of *Learned Optimism* (New York: Random, 1990) has done ground-breaking research in this area. Seligman, who is a professor of clinical psychology at the University of Pennsylvania, has developed a typology of successful action based on how one processes thoughts (optimistic vs. pessimistic) as they relate to considerations of time, space, and person. In an attempt to apply Seligman's work to optimal trading performance consider Figure 11-1.

Confidence

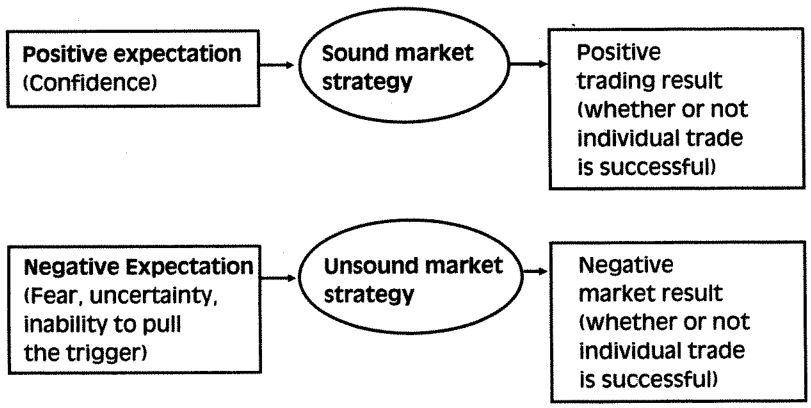
In *The Innergame of Trading* we spoke of the importance of confidence, of expecting the best of yourself. We stated, "Trading constantly presents us with obstacles and opportunities. And that expecting the best of yourself is the most effective means for dealing constructively with both of them." So, what is confidence? It is both expecting the best of yourself and assuming (believing in) a positive outcome in your trading. Fear, or the inability to pull the trigger, is just the opposite. It is a negative expectation of what is to come BEFORE IT HAPPENS!!!

Think of the many times you had to make a difficult phone call. Remember how your expectation (lack of confidence) affected what you were feeling, consider how it dictated what words you chose to use and in what tone of voice and with what result.

Figure 11-1 Characteristics of Optimistic and Pessimistic Thinking as Related to Trading

	Good Trades	Bad Trades
Optimistic	permanent pervasive personal	impermanent isolated impersonal
Pessimistic	impermanent isolated impersonal	permanent pervasive personal

Figure 11-2 Illustration of How Expectation Determines Behavior



Consider how this insight might relate to your trading. Figure 11-2 demonstrates these expectations graphically.

Successful Trading

A statistics professor we knew years ago once exclaimed, "Torture the data long enough and they will confess to anything." This observation applies equally well to market axioms, charts, money management, commodity cash price tables, futures price-action, pattern probabilities, and Elliott Wave counts: When they are not self-fulfilling prophesies, they are always, yes, always subject to individual interpretation. And there once again is the rub!

> **"It is not the mountain we conquer, but ourselves."**
>
> ***Sir Edmund Hillary***

Isolating your particular focus and consistently applying proven market strategies, which satisfy the criteria we have discussed earlier—and at the same time feeling good, that is to say comfortable and automatic with its use is the ultimate key to trading success.

What follows are what we believe to be the principles of successful trading.

Principles of Successful Trading

- Define your loss
- Believe in yourself and unlimited market possibilities
- Have a well-defined money management program
- Don't buy price
- Don't take tips
- Don't trade angry or euphoric
- Trade aggressively at your numbers and points
- Focus on opportunities
- Consistently apply your trading strategies and rules
- Be highly motivated and goal oriented
- The trend really is your friend
- When in doubt, stay out
- Don't overtrade
- Know how to use orders
- Never average a loss
- Take small loses, big profits
- Have no bias to either side of the market
- Don't pyramid
- The crowd is almost always wrong
- Concentrate on one market
- Preserve capital
- Think in probabilities
- Always trade in a highly positive and resourceful state of mind
- Act in certainty
- The market is never wrong

Trading presents many challenges but, as with most things in life, persistence and patience, confidence and competence, and above all a willingness to pay the price will give you the desired result.

In *The Mental Game* (NY: Viking Penguin, 1990), James Loehr writing about tennis strategy observes:

"Many players believe they must do something very special and different on big points. As a consequence, players often break from the pattern and style of play that got them to the big point. Going for too much too early is a strategy breakdown. Going for the low-percentage winner is particularly tempting on the critical points (to get the high-pressure situation over with), but generally spells failure.

> **"Improve your feeling about yourself and your situation will improve."**
> ***Anonymous***

"Another common way of breaking down strategywise on big points is to suddenly start pushing the ball back, hoping your opponent will make an error. Shifting to a very conservative, unaggressive style on the big points in order to keep your errors to an absolute minimum will be about as effective as going for too much too soon. The old dictum, never change a winning game, still holds. Whatever you did to get to the big point, continue doing. As a general rule, you will be most successful if you learn to play offensive, high-percentage tennis on critical points. You become the aggressor and work to get your opponent to make a forced error, without making an error yourself.

"To do this, you must know your own game well. Your general strategy for big points should be worked out well in advance of your match. And breaking down is when you don't follow it."

This analysis is as true for trading as it is for tennis. In fact trading could be called a state of mind, an exciting and challenging contest, that is deeply satisfying and financially rewarding. Some top traders view it as an art form, not unlike martial arts. And like these other disciplines, trading requires its own discipline in the form of appropriate goals, attitudes and strategies.

Your Game Plan

- Rehearse mentally
- Practice an open, flexible, non-defensive state of mind
- Practice patience in all things; it will improve your trading
- Pace yourself physically and emotionally
- Trading is not about proving something—to yourself or anyone else
- Condition yourself regularly for trading success

The Big Picture

There is an old Hindu legend that at one time all men on earth were gods, but men so sinned and abused the Divine that Brahma, the god of all gods, decided that the godhead should be taken away from man and hidden someplace where he would never find it again to abuse it.

One god said, "Let's bury it deep in the earth."

Brahma said, "No, man will learn to excavate and find it there someday."

Another god said, "Then let's put it in the deepest sea."

Brahma said, "No, man will learn to descend to the bottom and find it there, too."

A third god suggested, "Why don't we hide it on the highest mountain?"

Brahma said. "No, man will climb the highest mountain. I have a better place! Let's hide it down in man himself. He will never think to look there."

Within each of us is the power to accomplish what we want in trading and everything else if we just stop looking outside ourselves. There are no magic bullets in trading. No Holy Grail. No secret elixirs. Any one simple strategy when applied properly will work; the key resides always in the development and fulfillment of our own personal charac-

> **"One must be a god to be able to tell successes from failures without making a mistake."**
>
> ***Anton Chekhov***

teristics: confidence, judgment, courage, fortitude, intellect, prudence, and commitment.

We have once again come full circle, as traders and as human beings; the uncertain is always confronting us anew with spectacular challenges and opportunities in a 360-degree universe of unlimited possibility. The choice is always ours.

Success in trading!

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