Commodities Corporation's   The Michael Marcus Tape

The following are the notes taken from the Mike Marcus video. Comm. Corp was essentially a trading university where traders learned to trade and perfect their skills. In the course of their employment the traders were asked to prepare their trading philosophy which was archived. Commodities Corporation also made traders do write-ups when they lost money or "got knocked out-of-the-box." These "knocked out-of-the box" papers focused on how they failed and how they were going correct their problems. All of these were archived and available to read or watch. In my opinion, these were an invaluable resource for all traders to learn from. I just wish they were now available on a web-site. I will discuss some of these in a later post.

As most of you know Commodities Corp. eventually produced more than its fair share of super-star hedge fund managers. I think this was due to the sharing of those trading philosophies and the money management skills that were passed down by the founders and first generation traders to the second generation traders. As for myself, I learned a lot of my technical analysis skills from Glen Olink, who I sat across from for a number of years while at Cacao Barry Merchants / Cocoa Merchants Ltd. Glen was a very patient teacher. He made me learn technical analysis to which I am eternally grateful. I will never forget our conversations and him always following up by asking me why? He forced me to rationally defend my positions with well thought out and persuasive arguments. He also forced me to search for the truth and not to just take things at face value. He daily made me track and graph by hand the intra-day market movements of number of commodities. This was a pain to do but it eventually taught me "market feel" which is an invaluable ability for any trader to learn.

I also learned a lot from the folks at Comm. Corp by watching, following and filling their orders. From time to time, it was a real pleasure to actually sit down and talk to them when they came into our offices. I remember dealings with Marcus, Kovner, Grenville Craig, Craig Witt (supposedly they only trader to have a yearly 1000% return in back to back years) and others.

On the execution front, I was told that Louis Bacon did the bulk of Marcus's trades but I got a lot of Mike's currency trades, his soft commodities trades and other trades when he wanted to go unnoticed in the markets. I will give you one example. I remember talking to Mike and him telling me, "never hit a limit-up bid or take a limit-down offer." Both of those statements made perfect sense to me. Back in those days inflation was running rampant and the commodity markets could run in either direction literally for days.

So the story that I have is this. Mike calls up and asks me to check the pools in corn or wheat (I can't remember which). Let's say it was wheat and it is offered limit-down in pools across the board. I call Mike back and tell him the pool amounts that are offered at limit-down. He then tells me to "buy 'em", buy them all. I said, you just told me the other week never lift a limit-down offer. He says buy ‘em all and hangs up. So I call the floor broker and tell him to buy all the pools. Within minutes the market is reversing from limit-down to unchanged. Our phone bank, which had 100 lines, lights up like a Christmas tree. Everyone at Commodities Corporation is calling in asking what’s going on. I tell them to talk to Marcus he’s the one. Boy, were they pissed. Eventually the market closed limit-up and ran for several days afterwards. To this day I don’t know what he saw or knew but it was a heck of trade. Super timing.

An important lesson that I learned from watching all these Comm. Corp. traders was the belief that you can win in the market place but your “edge” or system that you use needs to agree with your own personality. If there is a “disconnect” then you are not going to be successful. Trading has a large psychological factor to it. If the system that you use leaves you feeling unsure and nervous about pulling the trigger then you may need to change things. Trading has two types of capital that must be managed – **financial capital and mental capital**. In this case, losing a lot or being unsure of your system drains you of your mental capital. You don’t want to do that. Losing either your financial or mental capital will knock you out of business. So protect both equally well.

Finally, Comm. Corp. taught me to see the signal, like the signal, follow the signal. If you follow your system /methodology then over time your edge will kick-in and you’ll end up ahead. One last point that I would like to make is to trade as close to the “danger point” as possible. I will explain this concept later in a further post.

Now to the Marcus notes

Please note black fonts represent Michael Marcus‘s thoughts while the **blue font words are my interpretations.**

Mike Marcus talks about taking a position. When the following three:

1). Fundamentals

2). Charts

3). Market Action

all agree this is the “Sacred Position” **back up the truck and load up**.

Wait for all three to line up and then use close stops. You won’t be stopped out.

But there is a trade-off between being stopped out at a loss and size of losses versus size of profits. **This to me is one of the key aspects to trading. From a psychological standpoint what is more important to you? How much does your intellect/ego need to be fed? Does your passion to be “right” drive you so much that you are unwilling to accept a loss to your wallet?**

Eventually there will be situation where you <u>hope</u> you'll be right if you hold on just a little longer. You start praying that things will shift and the fundamentals will work their way through thus satisfying your intellect's ego. This is the time that you need to pick up that book about Nick Leeson of Baring's and read it.. But if you are truly snake-bitten the market will continue to move away from your view point – thus creating a serious risk that you'll go out of business because if you can't check your ego and admit that you are wrong. Remember, if there is a catastrophic loss you are out of business and you don't even have the chance to make it back.

1). **Mike talked about giving your intellect the best chance to be right (this is in effect the real fundamental approach).** However, when you're stopped out you take a big loss. Thus placing a stop above or below a six week high or low (depending if you're short or long) seldom happens but when it does you'll eat a big loss. **To do this type of trading you need to be well capitalized and trade a limited amount of exposures.**

2). A moving average strategy is slightly better. Using a two or three week high or low becomes your stop-out level. You'll be stopped out more often and might miss being right but losses will be smaller. (Combination of 1 & 2 good)

3). Use a one or two day high if short or a one or two day low if long. You won't lose a lot of money but you will be stopped out a lot. You minimize your losses by improving timing – this is done through market feel.

The following is the best description of market feel that I have seen.

Traders need a sense of day-to-day fluctuations. A good trader should be able to read a newspaper and from just reading the articles create a mental image of just how much his/her market would be impacted by such events. Effectively a trader should be able to determine just how many points up or down the markets would move given the news.

Mike also said if you don't have "feel" then you can never be a great trader. I would agree with that. I have known a number of fundamental traders that were exceptionally bright on the major trend of a commodity or currency. They knew all about the factors that would impact that particular trade but could not time exactly when to get in and get out. Therefore, they would get in early and have to wait and wait for the move to occur. This sounds good but if you're trading USD/BRL this can be exceptionally painful given the high carry cost of maintaining this position. Thus every day that passes and the move <u>doesn't</u> occur it costs you. Or if you do catch it right, every day that you <u>over stay</u> after the move occurs costs you. The key to trading that currency is to trade it just as it starts to move and get out just as it stops moving. This is very difficult to do but can be done given that you combine a keen sense of market feel with market action and market fundamentals. Therefore catching the move from

1.60 to 2.45-2.50 and selling on the blow-off is a prime example of blending market action, market feel and fundamentals...

Look for breakouts of formations.

Look for 5 day high and ride stops. Then as market pulls back watch if there is follow-through

Look for buying on-the-close

Use mode 31 on Comtrend. If the market is hot it won't break the day chart. **(Sorry, I can't remember what mode 31 showed but I am guessing that it had to be some intra-day chart)**

If you have picked the right time it will hold the low. Expect strength each day (if in an up-trend) as it gets rolling.

Be more willing to spend paper profits rather than real equity. It's the only way you can ride your winners. **In my mind this is another absolute truth. I could probably write a paper on this alone. The idea is that nothing goes straight up or down. There will fluctuations and reactions. The key is to know how much of a reaction to expect. What is normal for this commodity, currency or stock if it is trending?**

Another strategy that I have used over my career is to roll-up or roll-into an option. If you are already in an option call and the market has moved dramatically your way then you may want to take some money off the table by rolling up to a higher strike. Likewise, you may have been holding some equity, future or some forward type position with a delta of 1. To lessen your risk while still participating in the move /roll your position into an option. This allows you to still participate in the move while taking money off the table once again.

If you have no "feel" it's pretty tough. **Mike was kind when he said it that way. But what he really meant was if you have no "feel" don't even try to be a trader. In my opinion most of the really good traders have spent time on the trading floor or on spot trading desk. It is in those types of environments that you really learn market feel.**

Take for example, you're on a spot currency desk and someone calls you up for a price. Here is what you have to do in a blink of eye. Determine what is the trend? What time of day is it? Who is calling? Where is the liquidity at if I am wrong? Can I get out with a minimum of pain if I am wrong? Do I have an axe to grind, meaning do I think I want to be long or short and therefore I am willing to show him/her a better bid or a better offer. What are the other markets telling me? Is there something going on in the debt, metals, or equity markets that may influence this guy's decision to pull the trigger now? What news is out there that may be driving this other trader's decision to trade?

If you weren't right that day you're out. Thus your judgment isn't crowded with worries.

Not worth it if it distracts you. Defend your psychological capital.

Let me talk about this one a little. I was a partner with Ralph Vince in a local hedge fund awhile back. Ralph is an incredibly bright individual who has worked with George Soros, the Abu Dhabi Investment Authority and others. He has written a number of books on risk and portfolio management. Ralph is phenomenal computer programmer and I learned tremendous amount from him on that front. Hopefully, I taught him a little about options. Nevertheless, Larry Williams and Ralph were very good buddies. Ralph and Larry designed this system called Optimal F. The idea is take your trading system then back-test it against a variety of stocks, commodities, currencies etc. thus realizing a set of returns. The returns then will form a distribution similar to a bell shaped curve. Now if you want to maximize your results – make as much money as possible over some time period then you need to trade at the peak of that distribution curve. Anything to the left or the right of the peak will produce results that will be inferior. The problem with this is that the swings to your account are enormous. No mere mortal other than Larry Williams could trade it. You got to have enormous brass ones and extreme mental toughness to trade that way. Imagine taking $10,000 watching all the swings that turn it into $4 million and then back to $2 million. Most people can't handle that kind of mental / psychological pressure.

Trading books also tell you to cut back on your position if you can't sleep at night. I believe in that. What I found to be true is that if you "feel" that something is wrong than listen to it. My belief is that "gut feel" works. This is because if you have been doing your homework and have kept up on all of your readings your sub-conscious will sometimes take over and start to put together a string of separate small facts that on the face of it don't seem that consequential nevertheless the sub-conscious makes some cohesive sense of the individual facts and says get out. I usually heed those warnings.

Be willing to suffer small wounds but not big losses.

In a normal year, only six markets get hot. The following strategy will put you in for those markets. Think of yourself as a Floor trader till you get ahead and then with paper profits become a trend follower. **I thought that this was especially insightful as to the number of markets that get hot in a single year. I also think Mike gives real insight about thinking like a floor trader and then shifting to a trend follower wants you have built a cushion and can confirm that the market is trending.**

This next question came from Glen Olink my teacher at Cocoa Merchants Ltd. What if the market is running? Mike says take a smaller position until it forms a congestion area, then a throw a stop under it. **Again at least for me this is significant especially from a behavioral**

finance perspective. Basically put something on and start participating in the trend. Are you going to put a full position? Hell no, but you want to get something on and feel like your participating. Again this needed market "feel" feedback. Once you get a congestion period you can weigh the risk/reward ratio a little better and determine where best to put stops (usually under the congestion's low) and put on a full position at that point.

Amos Hostetter (See Commodities Corp.'s Markovitz – book on Hostetter) would buy a dip and put a stop under that low. Go in on the very first reaction. The first reaction will be the bottom for awhile.

Market action – how does the market respond to news environment? Given the news what should market do today. **In the following Mike describes more of what market feel really is.**

Convert expectations into price change for interest rates, all commodities, for my commodity/stock

What should it have reasonably done given the news?

Is it in sympathy with other markets?

You should have a sense of how it should act. How it reacts to other commodities. the 1980-81 Yen up on day as others are buried. The 1980 grain bull market disparity between wheat, corn and soybeans.

Is commodity behaving itself given what else is going on?

Also does it have tone that day?

Are the dips being bought?

Is there underlying support?

Are there large orders being executed and how are the affecting the market?

This only works when trends are in effect.

If markets have not conformed then you are betting on a sustained trend emerging.

Is the environment inflationary or deflationary? If not clear get out and don't try.

Money Management

Don't like to lose more than X% of original equity on original trade.

If X% = $X Thus if stop is hit then you have to work-out the number of contracts to trade that will equal that % of equity.

Have to lose consistently to be beaten.

Whole idea is consistency

Sooner or later everything is easy. **Again this goes back to what I learned from the folks at CC see the signal, like the signal, follow the signal.**

Psychology

Know yourself so that you know when decisions are based on market and trading and when on emotion.

You're letting a loser ride why? At that particular moment you can't swallow the pain.

Why cut a winner short for no good reason?

Entering trades without a good reason.

According to Mike market action more important than charts.

Make sure reactions are behaved 40% reaction but Mike likes 33% retracements.

For beginning traders Mike suggested that they should base 40% of their trades on fundamental factors and 60% on the technicals.

All else defend losing until opportunity shows itself.

I had some discussions with Mike on the psychological aspects of trading. These are some of his thoughts and my interpretations and expansion of his ideas.

Mike could never really trade cocoa. I remember calling him one day and telling him he was down $1 million on his cocoa trade. He said he wasn't worried as he was up $10 million for the month in his personal account with his other trades. We then discussed this trade. He said he felt bad about the loss but he felt that he almost had to trade it since Commodities Corporation was founded on Helmut Weymar's cocoa trading models. He felt that he owed it to the firm to try and at least trade it. Nevertheless, he said he felt it didn't have the right rhythm or speed that he was accustomed to. I had never thought about that aspect before. That some commodities, currencies, stocks don't fit your personal temperament and that we all need to find out which does fit.

Consequently, I am a huge believer that your trading style/ your edge has to agree with your personality for you to be successful. As an example of this I'll relate this story. Way back when I was interviewed by Richard Dennis for a slot as one of the Trading Turtles. I was interviewed but I didn't make the cut. But in a way I am rather grateful that I didn't get chosen. You see trend following just doesn't suit me. As a matter of fact I cringe at the mere fact of following some moving average(s). From an intellectual standpoint it really annoys me. And I remember Richard Dennis saying that he could teach anyone all his trading secrets and most of them wouldn't be successful because they couldn't be disciplined enough to follow the rules. Again, knowing what makes you tick and what agrees with your personality will help you immensely.

Money Management

The (TEP) Trader Evaluation Program was a program set up to identify new traders. To be sure I am not quite sure what was needed to qualify for admittance. Nevertheless, I knew Commodities Corp. had a special pedigree that they favored. If you look at Comm. Corp.'s early 1970s brochure and its mid 1970's brochure you'll see what I mean. The academic credentials were rather impressive. The people there had multiple degrees from some of the best schools in the world. They definitely had brain power.

We were given the initial sum of $35,000 to trade for a year. Now why this amount? This was the initial amounts that the founders had when they started and they all knew the trials and tribulations of managing something like. Mike once said it was harder trading such a small amount rather than a larger amount. This was because you couldn't diversify your risk as you would if you a larger account. Secondly, when your account is this small just to get a good trade off at times you have trade bigger than you want so that you can layer in and layer out your orders as you enter or exit a market. From a money management perspective you knew you were violating your money management rules but you at least knew you were violating them. So you really had to pick and choose your opportunities more carefully.

Finally, with a small account you can get bigger returns but your risk of failure is a lot greater. What I learned from CC and other traders over my trading life is that if you have an edge you want to grind it out for as long as you can. Over time the edge will win out. Think of yourself as a casino. The casino always has the long term edge. Sure it may lose big from time to time but it is adequately capitalize so that it can keep playing the games and earn its edge over the long haul. Trading shouldn't be flashy instead it's about taking the emotion out and grinding it out every day. As for my TEP results I ran my account up to $132,000 plus and was second to Paul Tudor Jones that year.

Homework

Glen forced me to think things through. One of my assignments was to follow one particular commodity for a whole year and track all of its supply and demand reports. This was a real eye opener for me. Both Glen and the rest of the folks at Commodities Corporation told me to forget everything that I learned in school (Wharton) and to challenge everything. Think for yourself was what they suggested. They said you'll hear a lot of stuff from Wall Street some of it may be true, some of it may be false, some it may be true only sometime and some may false sometimes. My job was to find out for myself when things worked and when they didn't hold up. The simplest way I can explain is with the following story.

The one market that I focused on for a whole year was cocoa. This made the most sense since Cocoa Merchants Ltd. was one of the largest cocoa dealers in the world. I therefore was privy to some of the best information on the cocoa market. This should be easy. As the year went along I started to form my opinion that cocoa was going to go higher. I kept reading reports from the origins that they were having trouble gathering the crops. First there were torrential rains in the up country access was going to be very difficult. Then there were reports of roads being swept away by the floods. Then reports that the lorries / trucks didn't have petrol to go into the plantations and get the crop. Then there were reports that the farmers didn't have bags to put the cocoa in. Then reports came in that the farmers had no string to tie the bags. Then there were reports that dockworkers were going to go on strike. In the end it was one Ghana's biggest crops ever and the prices slid for years. To this day I still think you only trade cocoa from the short side (lol). But from this I learned a valuable lesson, when it's in the best interest of someone or something (think of any government institution) to tell you a lie they will do it. Trust no one. And if they deny it the three times they really are in a mess. (lol)

Good Behavior

One of my other big beliefs is that to be a good trader you need to learn from a good trader. You can learn from books. You can learn on your own and make some expensive mistakes or you can learn from a successful professional. Learn from a professional.

Danger Point

Another point that I learned from Commodities Corporation was trying to get as close to the "danger point" as possible. What I mean by this is you want to put on a position as close to your stop-out point as possible. This may sound crazy but from a financial and mental capital stand point this makes perfect sense. This is because both of these ideas kind of go hand-in-hand. First from a mental perspective, if I am close to getting stopped out I am willing to take that trade all the time because I won't have to suffer debilitating loss of capital. I can sleep soundly knowing that a loss won't be devastating. I won't have a restless night worrying

about whether I got the right position on at the right level. Thus I conserve my mental capital.

As for the financial capital if I have done my homework the loss is acceptable and I am willing to do it over and over since I know I have a long term edge in my trading style. But if I am right, I am at the ground floor of either a major reaction or at best the start of new leg of that trend. Commodities Corp has taught me to like my losers thus I have no psychological baggage to hold me back from further trades that may prove to be successful. The key is picking the right stop-out point that says if it is violated in ain't coming back.