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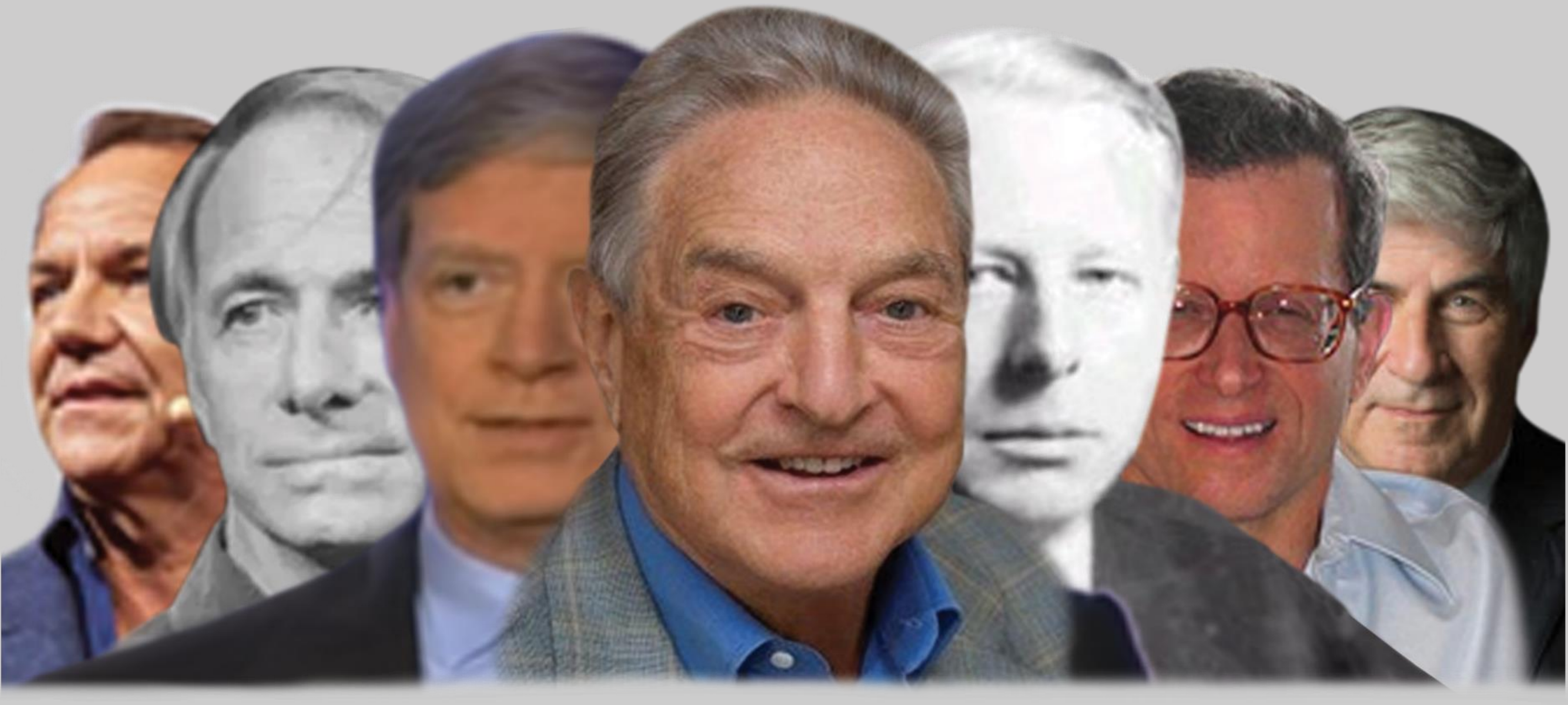

LESSONS FROM

THE TRADING GREATS

VOL. 1

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Introduction

One of the ironies I've learned through years of dissecting the habits and practices of top traders is that there is nothing special to what they do. I'm not implying that what they're able to do isn't impressive; of course it is. I simply mean that they have no *special* or *secret* knowledge or ability that's unique to them.

Most people start out in the markets looking for that "thing"; whether it be a special insight or indicator or strategy or whatever, that will show them how to win. They think if they can just find the secrets to what make the greats great, then they'll be set. But in reality... if there's *any* secret at all, it's that there is no secret.

Does that mean you can read a few trading books and instantly become a great trader? Well, let me ask you this: can you read the classic *Ben Hogan's Five Lessons* on golf and go out and play scratch golf? Of course not! And that's because even though each will have all the foundational knowledge you need to succeed, they don't supply the practice that ingrains the lessons and transforms that knowledge into wisdom.

Here's how the legendary Jesse Livermore put it, "The training of a stock trader is like a medical education. The physician has to spend long years learning anatomy, physiology, materia medica and collateral subjects by the dozen. He learns the theory and then proceeds to devote his life to the practice."

The practice is the hard part. It takes time and a Herculean effort. Blisters and portfolio losses. There are no short-cuts. But practice without knowledge is wasted effort. It's like trying to run on your hands because nobody ever told you to use your feet!

Below you'll find the knowledge given by some of the greatest traders of all time. Read it, learn it, and most of all… **practice it.**

Jesse Livermore: The Original Macro Maestro

Jesse Lauriston Livermore
(1877—1940)

"Boy Wonder", "Boy Plunger" and the "Great Bear of Wall St." are a few of the monikers Jesse Livermore was known by.

Livermore was immortalized in the trading classic *Reminiscences of a Stock Operator* by Edwin Lefevre — a book your author has read countless times over the years and *still* pulls new wisdom from with each revisit.

Reminiscences has stood the test of time because it, more than any other book, explains the fundamental truths that lie at the heart of successful speculation. It's no doubt a reflection of Livermore's deep and intimate understanding of this great game.

All of the important truths that a speculator needs to understand were plainly communicated by Livermore over 75 years ago.

Learn How to Lose

> *An old broker once said to me: 'If I am walking along a railroad track and I see a train coming toward me at sixty miles an hour, do I keep on walking on the ties? Friend, I sidestep. And I do not even pat myself on the back for being so wise and prudent.'*

To be a great trader you have to be a great loser. Sounds like a contradiction right? Well it isn't. The fact is, great traders will typically have more losing trades than profitable ones. They'll spend more time in an equity drawdown than at new highs. Some of this is due to the natural 90/10 distributions of markets (Pareto's Law), but much of it is actually by design.

Mark Spitznagel wrote in *The Dao of Capital* that the most valuable lesson he learned from his Chicago trading pit mentor, Everett Klipp, was that "you've got to love to lose money." If you love to take small losses then you'll never take a large one. That's important because it's the large ones that'll kill ya'.

Humans are naturally averse to losing (obvious statement). Our psychological programming attaches a lot of nonsensical meaning to taking losses in the market. We are evolutionarily wired to be bad emotional traders. The key is to invert this instinctual response and learn to "love to lose". Livermore talks about this inversion:

> *Losing money is the least of my troubles. A loss never bothers me after I take it. I forget it overnight. But being wrong — not taking the loss — that is what does damage to the pocketbook and to the soul.*

And here's a simple and yet KEY… ***KEY...*** fundamental truth to good trading: never add to your losers, sell what shows you a loss, and let run what shows you a profit.

> *Of all speculative blunders there are few worse than trying to average a losing game. My cotton deal proved it to the hilt a little later. Always sell what shows you a loss and keep what shows you a profit. That was so obviously the wise thing to do and was so well known to me that even now I marvel at myself for doing the reverse.*

Livermore's occasional failure to follow this rule is what led to the multiple blowups he experienced throughout his career. He lost when he failed to follow his advice that it's "foolhardy to make a second trade, if your first trade shows you a loss. Never average losses. Let this thought be written indelibly upon your mind."

Livermore learned the hard way that our natural instincts must be flipped.

> *Instead of hoping he must fear and instead of fearing he must hope. He must fear that his loss may develop into a much bigger loss, and hope that his profit may become a big profit.*

The Importance of Understanding General Conditions

> *I still had much to learn but I knew what to do. No more floundering, no more half-right methods. Tape reading was an important part of the game; so was beginning at the right time; so was sticking to your position. But my greatest discovery was that a man must study general conditions, to size them so as to be able to anticipate probabilities.*

Not many people realize this, but Livermore was the original "global macro" guy. His "greatest discovery" was the importance of macro — or what he called "general conditions".

He had the same realization that hedge fund manager Steve Cohen had decades later, which is "that 40 percent of a stock's price movement is due to the market, 30 percent to the sector, and only 30 percent to the stock itself."

After Livermore made this discovery he said "I began to think of basic conditions instead of individual stocks. I promoted myself to a higher grade in the hard school of speculation. It was a long and difficult step to take."

This revelation completely changed the way he approached markets and trading. While everybody was piking around, losing money playing the “stock picking” game, Livermore was studying general conditions. He now understood the simple fundamental truth that you want to be long in a bull market and short in a bear market.

- *I think it was a long step forward in my trading education when I realized at last that when old Mr. Partridge kept on telling the other customers, 'Well, you know this is a bull market!' he really meant to tell them that the big money was not in the individual fluctuations but in the main movements — that is, not in reading the tape but in sizing up the entire market and its trend.*

- *Disregarding the big swing and trying to jump in and out was fatal to me. Nobody can catch all the fluctuations. In a bull market your game is to buy and hold until you believe that the bull market is near its end. To do this you must study general conditions and not tips or special factors affecting individual stocks.*

It’s when Livermore started playing the macro game that he really started making the big money.

- *I cleared about three million dollars in 1916 by being bullish as long as the bull market lasted and then by being bearish when the bear market started. As I said before, a man does not have to marry one side of the market till death do them part.*

- *But I can tell you after the market began to go my way I felt for the first time in my life that I had allies — the strongest and truest in the world: underlying conditions. They were helping me with all their might. Perhaps they were a trifle slow at times in bringing up the reserves, but they were dependable, provided I did not get too impatient.*

General conditions (macro) continue to be — BY FAR — the biggest potential source for alpha in trading. That’s because most market participants are still focused on the stock picking game and remain completely ignorant of the most significant driver of their stock’s price action. Learning to read the underlying conditions is like swinging the trading equivalent of Thor’s Hammer… it makes that much of a difference.

Patience, Psychology and the Dangers of Overtrading

> *It sounds very easy to say that all you have to do is to watch the tape, establish your resistance points and be ready to trade along the line of least resistance as soon as you have determined it. But in actual practice a man has to guard against many things, and most of all against himself — that is, against human nature.*

Livermore understood man’s foibles perhaps better than most. He made and lost multiple fortunes, the size of which, most could hardly fathom. He knew well the fundamental truth that becoming a great trader is as much about self-mastery as it is about market mastery.

Market Wizard Ed Seykota said "I think that if people look deeply enough into their trading patterns, they find that, on balance, including all their goals, they are really getting what they want, even though they may not understand it or want to admit it."

True professional speculation is often a tedious and boring affair, where one can go months without putting on a trade because the general conditions are not right.

> *There is a time for all things, but I didn't know it. And that is precisely what beats so many men in Wall Street who are very far from being in the main sucker class.*

Most traders that I see are not *really* in the game to make money by strictly following a sound trading process. They want quick profits; the thrill of gambling; high adrenaline entertainment. Basically the same lizard brain "wants" that drive the large profits for Vegas casinos.

This is why most people overtrade. And they overtrade a lot. Here's Livermore's thoughts on why that's bad.

> *There is the plain fool, who does the wrong thing at all times everywhere, but there is the Wall Street fool, who thinks he must trade all the time. No man can always have adequate reasons for buying or selling stocks daily–or sufficient knowledge to make his play an intelligent play.*

The overtrading by others brings us to another fundamental truth: that other's impatience can be our profits if we're willing to practice infinite patience.

> *The desire for constant action irrespective of underlying conditions is responsible for many losses on Wall Street even among the professionals, who feel that they must take home some money every day, as though they were working for regular wages. Remember this: When you are doing nothing, those speculators who feel they must trade day in and day out, are laying the foundation for your next venture. You will reap benefits from their mistakes.*

When putting on a trade it's better to be a little late than a little early. As Livermore put it, "don't take action with a trade until the market, itself, confirms your opinion. Being a little late in a trade is insurance that your opinion is correct. In other words, don't be an impatient trader."

Self-mastery leads to market mastery. Livermore said "the human side of every person is the greatest enemy of the average investor or speculator. Fear keeps you from making as much money as you ought to. Wishful thinking must be banished."

Price Action and Path of Least Resistance

> *There is what I call the behavior of a stock, actions that enable you to judge whether or not it is going to proceed in accordance with the precedents that your observation has noted. If a stock doesn't act right don't touch it; because, being unable to tell precisely what is wrong, you cannot tell which way it is going. No diagnosis, no prognosis. No prognosis, no profit.*

Livermore was one of the best at reading the tape. His years of studying price action gave him a sort of “sixth sense” for knowing what the market was doing and where it was headed. This is one of those “practice” elements where only so much instruction can be given… the rest needs to be learned and experienced.

But one of the important lessons that Livermore talked about is studying price action in order to determine the “path of least resistance”, saying:

> *For purposes of easy explanation we will say that prices, like everything else, move along the line of least resistance. They will do whatever comes easiest, therefore they will go up if there is less resistance to an advance than to a decline; and vice versa.*

The path of least resistance is all about understanding accumulation/distribution or consolidation/expansion zones. A chart is simply a two dimensional representation of supply/demand. The path of least resistance is the price level that supply/demand is likely to move towards based off past and current accumulation/distribution levels.

Learn to read supply and demand action with practice and your trading will become more fluid. Livermore stated, “It would not be so difficult to make money if a trader always stuck to his speculative guns — that is, waited for the line of least resistance to define itself and began buying only when the tape said up or selling only when it said down.”

A critical part to what he’s saying is to **wait** for the path of least resistance to present itself. Attempting to anticipate trend changes is a costly and foolish endeavor.

> *One of the most helpful things that anybody can learn is to give up trying to catch the last eighth — or the first. These two are the most expensive eighths in the world. They have cost stock traders, in the aggregate, enough millions of dollars to build a concrete highway across the continent.*

Trend reversals are a process, not an event. Livermore notes “that a market does not culminate in one grand blaze of glory. Neither does it end with a sudden reversal of form. A market can and does often cease to be a bull market long before prices generally begin to break.”

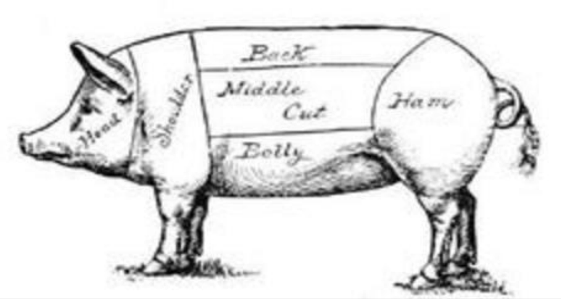
The trend is your friend and there are separate trends on different time intervals. The more trends that line up on each interval, the lesser resistance on the trade’s path.

Big Bets and Sitting Tight

- *And right here let me say one thing: After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight!*

- *Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money.*

The average trader is quick to take a profit and slow to book a loss. Going back to the importance of inverting our trading nature, it's as important to let profits run as it is to cut losses short. Remember, we'll lose more than we'll be right. So we need those winners to be significantly larger to pay for our losers. Livermore said, "they say you never grow poor taking profits. No, you don't. But neither do you grow rich taking a four point profit in a bull market."



Livermore explained successful trading plainly, "I study because my business is to trade. The moment the tape told me that I was on the right track my business duty was to increase my line. I did. That is all there is to it."

The fundamental truths of speculation, as laid out by Livermore three quarters of a century ago, can be summarized as follows:

- **Cut your losses**: Never average down and never *hope* losses reverse. Just cut.
- **Infinite patience:** Good trades are few and far between. Trade for profits, <u>not</u> for action.
- **Learn macro:** Understanding general conditions is essential to being a market master and not a piker.
- **Price action is king:** Learn to read the tape and don't argue with markets — they know more than you.
- **Big bet/sit tight:** Ride your winners for all their worth. This conviction comes with practice.
- **Self-mastery:** You are your greatest impediment to your own success. "Know thyself".

These lessons are as true today as they were then. As Livermore put it, "there is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again."

Ray Dalio: A Machine To Get What You Want

Ray Dalio is the founder of Bridgewater. Two years ago, Bridgewater surpassed Soros' Quantum fund for the title of most profitable hedge fund of all time; returning over $46 billion since inception.

In your author's humble opinion, Ray Dalio is one of the more original thinkers alive today. In the investing world he stands alone in his depth of understanding of how the "economic machine" works. His "principles" for life and management are like beautiful computer code designed to produce desired outcomes while stripping away the non-essential. The man is a philosophizing engineer taking apart and designing machines for all aspects of life. Dalio has devoted himself to pursuing truth at all costs (I know, it sounds like I'm fawning, but I admire the guy's thinking. He's also one of my three favorite traders next to Livermore and Soros).

It's this radical devotion to "finding out what is true and what isn't" that unnerves many and makes Dalio and Bridgewater easy targets for ridicule. The two have been frequent subjects of poor journalism. Recently, a few hack reporters have tried painting Bridgewater as cultish and its founder as an egomaniacal Jonestown leader.

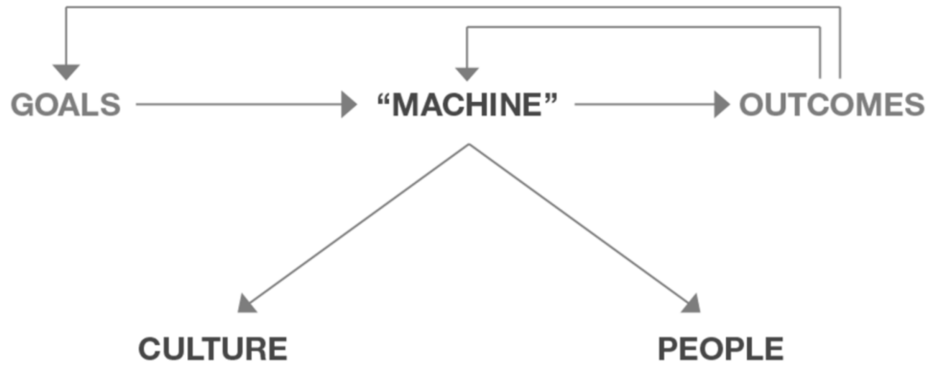
Nothing could be further from the truth. I've been lucky enough to spend some time at their headquarters in Connecticut and my opinion is that Dalio and company simply practice what they preach, which is "radical transparency". Yes, the culture is, well, radically different than anything you'll find elsewhere and definitely not for everyone. But it's also completely, perfectly, logical. He refers to the company as an "intellectual Navy Seals", which I think is a fair analogy.

Dalio has built a machine to produce a desired outcome. That outcome is excellent long-term risk-adjusted returns. There's no doubting he's been successful at it… or actually, *THE MOST* successful at it. Though different, or rather *because* of this difference, Bridgewater's unparalleled success is worthy of examination.

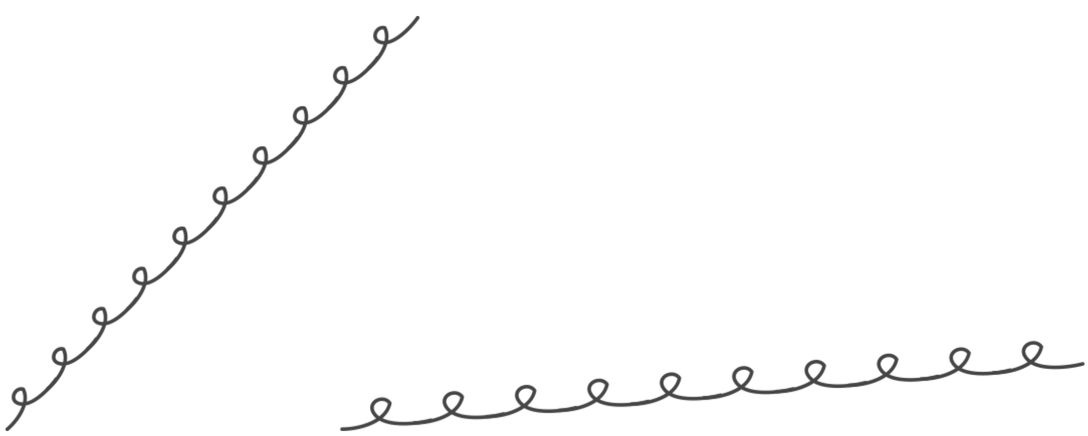
With that let's explore and dissect the thinking and practices of the man who's built the world's best money making machine.

On Philosophy and How to Build the Machine to Get What You Want

The framework for Dalio's philosophy and the way in which he views/evaluates the world is summed up in the following chart (via *Principles*).



> *That schematic is meant to convey that your goals will determine the "machine" that you create to achieve them; that machine will produce outcomes that you should compare with your goals to judge how your machine is working. Your "machine" will consist of the design and people you choose to achieve the goals. For example, if you want to take a hill from an enemy you will need to figure out how to do that—e.g., your design might need two scouts, two snipers, four infantrymen, one person to deliver the food, etc. While having the right design is essential, it is only half the battle. It is equally important to put the right people in each of these positions. They need different qualities to play their positions well—e.g., the scouts must be fast runners, the snipers must be precise shots, etc. If your outcomes are inconsistent with your goals (e.g., if you are having problems), you need to modify your "machine," which means that you either have to modify your design/culture or modify your people.*
>
> *Do this often and well and your improvement process will look like the one on the left and do it poorly and it will look like the one on the right, or worse:*



> ***I call it "higher level thinking" because your perspective is that of one who is looking down on your machine and yourself objectively****, using the feedback loop as I previously described. In other words, your most important role is to step back and design, operate and improve your "machine" to get what you want.*

This is a powerful model. It forces you to be objective in assessing the quality of your beliefs and habits, thus leading to improving outcomes through the feedback loop of continuous iteration.

Now compare this to how most people go after their goals. The average person's machine is akin to throwing spaghetti at the wall to see what sticks. Most people are reactive to life; never objectively assessing the quality of their beliefs or habits. This is why they never attain their desired outcomes.

The first step in effectively working towards your goals is to clarify what they are and why you *really* want them. From there you work backwards.

Without clarity of purpose and planning out the "how", you're doomed to walk circles. Stoic philosopher Seneca the Younger mentioned this in his writings *Tranquility of Mind*, "Let all your efforts be directed to something, let it keep that end in view. It's not activity that disturbs people, but false conceptions of things that drive them mad."

Law 29 of *The 48 Laws of Power* is: Plan All The Way To The End. Author Robert Greene writes, "By Planning to the end you will not be overwhelmed by circumstances and you will know when to stop. Gently guide fortune and help determine the future by thinking far ahead." The second habit in *The 7 Habits of Highly Effective People* is to "begin with the end in mind."

The end is always your starting point. Here's Dalio further spelling out the process for creating optimal outcomes.

> *My 5-Step Process to Getting What You Want Out of Life*
>
> *There are five things that you have to do to get what you want out of life. First, you have to* ***choose your goals****, which will determine your direction. Then you have to* ***design a plan*** *to achieve your goals. On the way to your goals, you will* ***encounter problems****. As I mentioned, these problems typically cause pain. The most common source of pain is in exploring your mistakes and weaknesses. You will either react badly to the pain or react like a master problem solver. That is your choice. To figure out how to get around these problems you must be calm and analytical to accurately* ***diagnose your problems****. Only after you have an accurate diagnosis of them can you* ***design a plan that will get you around your problems****. Then you have to do* ***the tasks*** *specified in the plan. Through this process of encountering problems and figuring out how to get around them, you will become progressively more capable and achieve your goals more easily. Then you will set bigger, more challenging goals, in the same way that someone who works with*

weights naturally increases the poundage. This is the process of personal evolution, which I call my 5-Step Process.

In other words, "The Process" consists of five distinct steps:

Have clear goals.

Identify and don't tolerate the problems that stand in the way of achieving your goals.

Accurately diagnose these problems.

Design plans that explicitly lay out tasks that will get you around your problems and on to your goals.

Implement these plans—i.e., do these tasks.

By and large, life will give you what you deserve and it doesn't give a damn what you "like." So it is up to you to take full responsibility to connect what you want with what you need to do to get it, and then to do those things—which often are difficult but produce good results—so that you'll then deserve to get what you want.

This mental model can — and should — be applied to every endeavor, especially trading and investing.

But objectively assessing the quality of our beliefs and habits is a lot easier said than done. It's the main reason why the majority of people keep spinning their wheels.

To be truly objective requires us to acknowledge frequent mistakes and wrong beliefs — both of which everybody is guilty of. I can assure you that you hold a number of completely false beliefs and have numerous poor habits. I know I do. And dealing with these are *initially* painful. That initial pain stems from the human ego.

Here's Dalio on the many harmful 1st and 2nd order effects of being ruled by ego and how to work to tame that ego.

- *Watch out for people who think it's embarrassing not to know.*
- *Be wary of the arrogant intellectual who comments from the stands without having played on the field.*
- *Don't worry about looking good - worry about achieving your goals.*

- *I believe that one of the best ways of getting at truth is reflecting with others who have opposing views and who share your interest in finding the truth rather than being proven right.*

- *There is giant untapped potential in disagreement, especially if the disagreement is between two or more thoughtful people.*

- *The pain of problems is a call to find solutions rather than a reason for unhappiness and inaction, so it's silly, pointless, and harmful to be upset at the problems and choices that come at you.*

- *The best advice I can give you is to ask yourself what do you want, then ask 'what is true' — and then ask yourself 'what should be done about it.' I believe that if you do this you will move much faster towards what you want to get out of life than if you don't!*

- *More than anything else, what differentiates people who live up to their potential from those who don't is a willingness to look at themselves and others objectively.*

- *Life is like a game where you seek to overcome the obstacles that stand in the way of achieving your goals. You get better at this game through practice. The game consists of a series of choices that have consequences. You can't stop the problems and choices from coming at you, so it's better to learn how to deal with them.*

- *If you can stare hard at your problems, they almost always shrink or disappear, because you almost always find a better way of dealing with them than if you don't face them head on. The more difficult the problem, the more important it is that you stare at it and deal with it.*

- *Unlike in school, in life you don't have to come up with all the right answers. You can ask the people around you for help — or even ask them to do the things you don't do well. In other words, there is almost no reason not to succeed if you take the attitude of One: total flexibility — good answers can come from anyone or anywhere. Two: Total accountability. Regardless of where the good answers come from, it's your job to find them.*

- *You'll see that excuses like "That's not easy" are of no value and that it pays to "push through it" at a pace you can handle. Like getting physically fit, the most important thing is that you keep moving forward at whatever pace you choose, recognizing the consequences of your actions.*

- *Life is like a giant smorgasbord of more delicious alternatives than you can ever hope to taste. So you have to reject having some things you want in order to get other things you want more.*

- *People who worry about looking good typically hide what they don't know and hide their weaknesses, so they never learn how to properly deal with them and these weaknesses remain impediments in the future.*

- *People who confuse what they wish were true with what is really true create distorted pictures of reality that make it impossible for them to make the best choices.*

- *People who acquire things beyond their usefulness not only will derive little or no marginal gains from these acquisitions, but they also will experience negative consequences, as with any form of gluttony.*

- *Since the only way you are going to find solutions to painful problems is by thinking deeply about them — i.e., reflecting — if you can develop a knee-jerk reaction to pain that is to reflect rather than to fight or flee, it will lead to your rapid learning/evolving.*

- *I believe that we all get rewarded and punished according to whether we operate in harmony or in conflict with nature's laws, and that all societies will succeed or fail in the degrees that they operate consistently with these laws.*

- *Though how nature works is way beyond man's ability to comprehend, I have found that observing how nature works offers innumerable lessons that can help us understand the realities that affect us.*

- *Success is achieved by people who deeply understand reality and know how to use it to get what they want. The converse is also true: idealists who are not well-grounded in reality create problems, not progress.*

- *I believe there are an infinite number of laws of the universe and that all progress or dreams achieved come from operating in a way that's consistent with them. These laws and the principles of how to operate in harmony with them have always existed. We were given these laws by nature. Man didn't and can't make them up. He can only hope to understand them and use them to get what he wants.*

- *I believe that our society's "mistake-phobia" is crippling, a problem that begins in most elementary schools, where we learn to learn what we are taught rather than to form our own goals and to figure out how to achieve them. We are fed with facts and tested and those who make the fewest mistakes are considered to be the smart ones, so we learn that it is embarrassing to not know and to make mistakes. Our education system spends virtually no time on how to learn from mistakes, yet this is critical to real learning.*

- *I learned that everyone makes mistakes and has weaknesses and that one of the most important things that differentiates people is their approach to handling them. I learned that there is an incredible beauty to mistakes, because embedded in each mistake is a puzzle, and a gem that I could get if I solved it, i.e. a principle that I could use to reduce my mistakes in the future.*

- *Sometimes we forge our own principles and sometimes we accept others' principles, or holistic packages of principles, such as religion and legal systems. While it isn't necessarily a bad thing to use others' principles — it's difficult to come up with your own, and often much wisdom has gone into those already created — adopting pre-packaged principles without much thought exposes you to the risk of inconsistency with your true values.*

- *Don't be a perfectionist, because perfectionists often spend too much time on little differences at the margins at the expense of other big, important things. Be an effective imperfectionist. Solutions that broadly work well (e.g., how people should contact each other in the event of crises) are generally better than highly specialized solutions (e.g., how each person should contact each other in the event of every conceivable crisis).*

- *Experience creates internalization. A huge difference exists between memory-based "book" learning and hands-on, internalized learning. A medical student who has "learned" to perform an operation in his medical school class has not learned it in the same way as a doctor who has already conducted several operations. In the first case, the learning is stored in the conscious mind, and the medical student draws on his memory bank to remember what he has learned. In the second case, what the doctor has learned through hands-on experience is stored in the subconscious mind and pops up without his consciously recalling it from the memory bank.*

- *It is a law of nature that you must do difficult things to gain strength and power. As with working out, after a while you make the connection between doing difficult things and the benefits you get from doing them, and you come to look forward to doing these difficult things.*

- *Ask yourself whether you have earned the right to have an opinion. Opinions are easy to produce, so bad ones abound. Knowing that you don't know something is nearly as valuable as knowing it. The worst situation is thinking you know something when you don't.*

- *There are far more good answers "out there" than there are in you.*

- *When you think that it's too hard, remember that in the long run, doing the things that will make you successful is a lot easier than being unsuccessful.*

- *Remember that experience creates internalization. Doing things repeatedly leads to internalization, which produces a quality of understanding that is generally vastly superior to intellectualized learning.*

- *At Bridgewater people have to value getting at truth so badly that they are willing to humiliate themselves to get it.*

For those of you who have studied the literature on performance psychology, you'll recognize a large number of influences in Dalio's work. Everything from the teachings of Buddhism to *est* to

Tony Robbins and many others are woven into Dalio's framework for success. In my opinion, his *Principles* are the most comprehensive and effective framework for getting what you want that I've read… and I've read a lot on this topic.

Dalio has taken this framework and has ruthlessly applied it to markets as well.

On the Nature of Trading

- *Alpha is zero sum. In order to earn more than the market return, you have to take money from somebody else.*

- *If you're going to come to the poker table, you're going to have to beat me. … We have 1500 people who work at Bridgewater. We spend hundreds of millions of dollars on research and so on, we've been doing this for 37 years.*

- *The nature of investing is that a very small percentage of the people take money, essentially, in that poker game, away from other people who don't know when prices go up whether that means it's a good investment or if it's a more expensive investment. Too many investors are reactive decision-makers. If something has gone up, they say, 'Ah, that's a good investment.' They don't say, 'That's more expensive.*

This is something many traders forget but it's a very important truth to keep front of mind. There's always another person on the other side of your trade. If you're buying, someone is selling to you. If you're selling, someone is buying from you. And everybody has the same goal: To Make Money! But the buyer and seller can't both be right. Obviously one party always has to be wrong. Couple that with the fact that some of the smartest people in the world are working with enormous amounts of money and incredibly advanced tools (like Bridgewater) to extract profits from the markets and trading doesn't seem so easy, does it?

Not to discourage you, that's just the reality of it. Consistently beating the market is as difficult as becoming an Olympic athlete… or probably even more so.

But it's not impossible either…

- *It all comes down to interest rates. As an investor, all you're doing is putting up a lump-sum payment for a future cash flow…. The big question is: When will the term structure of interest rates change? That's the question to be worried about. .. He who lives by the crystal ball [in trying to forecast interest rates] will eat shattered glass.*

- *Risky things are not in themselves risky if you understand them and control them. If you do it randomly and you are sloppy about it, it can be very risky.*

- *We think of commodities from a few different perspectives: as an alternative currency and store hold of wealth, as a growth-sensitive asset class, and as an asset with specific supply and demand considerations.*

- *The biggest mistake investors make is to believe that what happened in the recent past is likely to persist. They assume that something that was a good investment in the recent past is still a good investment. Typically, high past returns simply imply that an asset has become more expensive and is a poorer, not better, investment.*

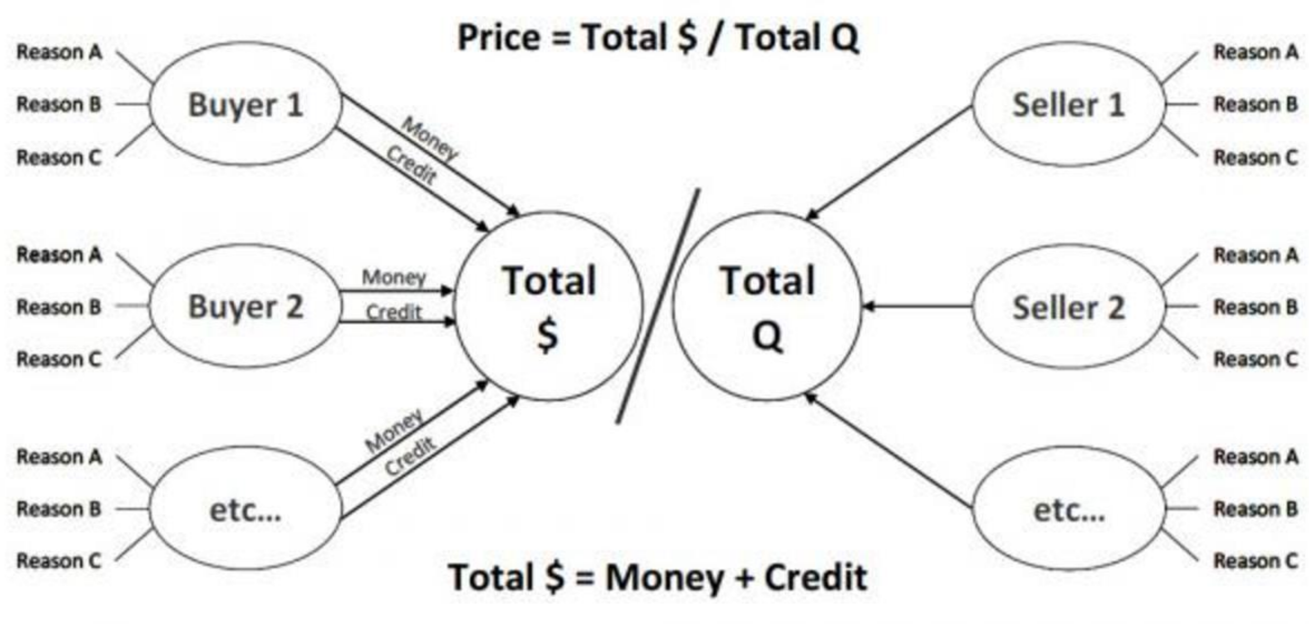
- *People tend to think that my success, or whatever you want to call it, has been because I'm a really good decision-maker. I think it is actually because I'm less confident in making decisions. So in other words, I never know anything really. Everything is a probability.*

- *You can't make money agreeing with the consensus view, which is already embedded in the price. Yet whenever you're betting against the consensus, there's a significant probability you're going to be wrong, so you have to be humble.*

On What Moves Markets and How to Profit From Them

If you're interested in macro — if you're a trader or investor, you should be — then it behooves you to take some time and read through Bridgewater's paper titled "How the Economic Machine Works". It's the best framework on how to view and understand markets and economies.

At the foundation of this framework is the Transactions Approach; which is a different way of looking at transactions and price discovery compared to classic economic supply and demand models.



> *Every time you buy something, you create a transaction and transactions are the building blocks of the economic machine. Understanding transactions is the key to understanding the whole economy. An economy consists of all of the transactions and all of its markets. Adding up the total quantity of transactions in all markets gives you everything you need to know to understand the economy. The biggest buyer and seller is the government, which a) through a central bank controls the credit in the economy and b) collects taxes and spends money.*

These transactions form markets and markets form economies. One of the keys to successful trading and investing is to understand who the buyers are, what their motivation is, and what the credit/liquidity picture looks like.

Following the transaction model we get to debt cycles (which you can read more about here). Here is the basic premise below (via *Economic Principles*).

ECONOMIC PRINCIPLES

- Everything is a transaction and one has to understand them to understand economics. They add up to:

  Three Big Forces

  1) Productivity
  2) The short-term debt cycle
  3) The long-term debt cycle

  Three Important Equilibriums

  1) Debt growth is in line with the income growth that is required to service debts.
  2) Economic capacity utilization is neither too high nor too low.
  3) Projected returns of equities are above the projected returns of bonds which are above the projected returns of cash by appropriate risk premiums.

  Two Levers

  1) Monetary Policy
  2) Fiscal Policy

- Economic and market movements are like a perpetual motion machine of the interactions of these.

-3-

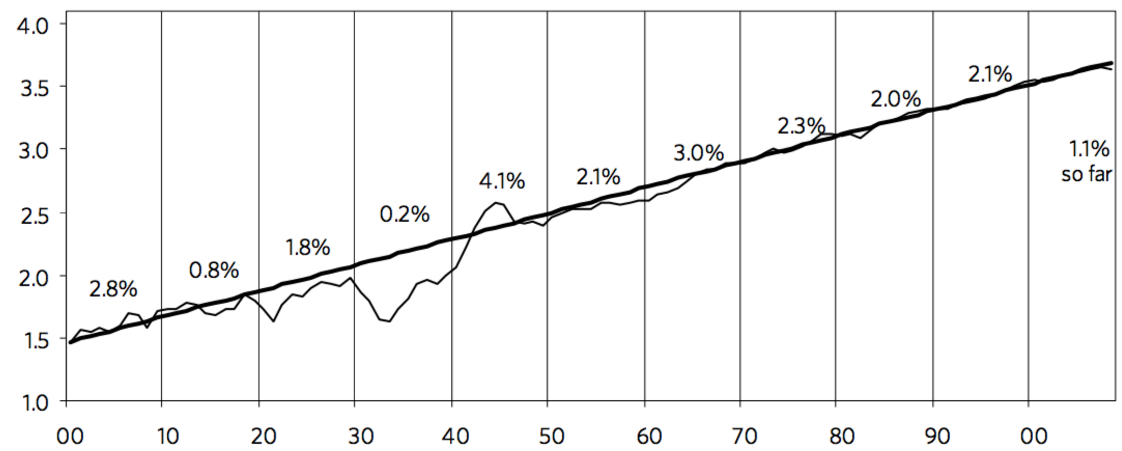
BRIDGEWATER

> *As shown below in chart 1, real per capita GDP has increased at an average rate of a shade less than 2% over the last 100 years and didn't vary a lot from that. This is because, over time, knowledge increases, which in turn raises productivity and living standards. As shown in this chart, over the very long run, there is relatively little variation*

from the trend line. Even the Great Depression in the 1930s looks rather small. As a result, we can be relatively confident that, with time, the economy will get back on track. However, up close, these variations from trend can be enormous. For example, typically in depressions the peak-to-trough declines in real economic activity are around 20%, the destruction of financial wealth is typically more than 50% and equity prices typically decline by around 80%. The losses in financial wealth for those who have it at the beginning of depressions are typically greater than these numbers suggest because there is also a tremendous shifting of who has wealth.

Chart 1

Real GDP Per Capita (2008 Dollars, ln)



Sources: Global Financial Data & BW Estimates

Swings around this trend are not primarily due to expansions and contractions in knowledge. For example, the Great Depression didn't occur because people forgot how to efficiently produce, and it wasn't set off by war or drought. All the elements that make the economy buzz were there, yet it stagnated. So why didn't the idle factories simply hire the unemployed to utilize the abundant resources in order to produce prosperity? These cycles are not due to events beyond our control, e.g., natural disasters. They are due to human nature and the way the credit system works. Most importantly, major swings around the trend are due to expansions and contractions in credit – i.e., credit cycles, most importantly 1) a long-term (typically 50 to 75 years) debt cycle and 2) a shorter-term (typically 5 to 8 years) debt cycle (i.e., the "business/market cycle").

I find that whenever I start talking about cycles, particularly the long-term variety, I raise eyebrows and elicit reactions similar to those I'd expect if I were talking about astrology. For this reason, before I begin explaining these two debt cycles I'd like to say a few things about cycles in general.

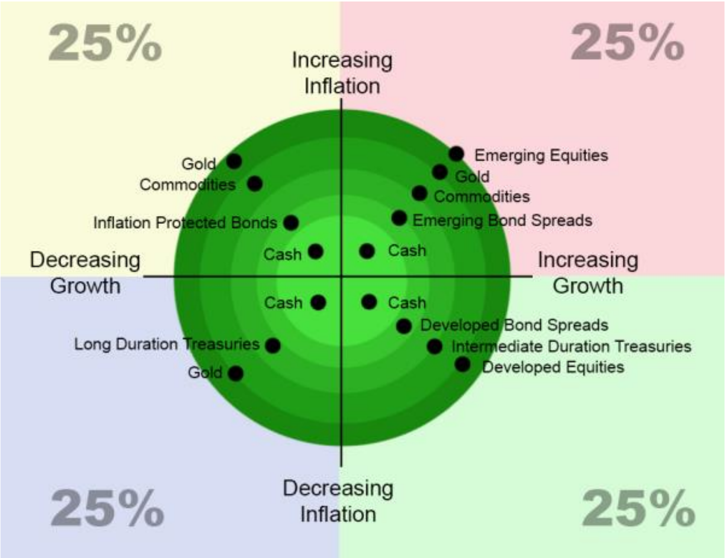
A cycle is nothing more than a logical sequence of events leading to a repetitious pattern. In a market-based economy, cycles of expansions in credit and contractions in

> *credit drive economic cycles and they occur for perfectly logical reasons. Each sequence is not pre-destined to repeat in exactly the same way nor to take exactly the same amount of time, though the patterns are similar, for logical reasons. For example, if you understand the game of Monopoly®, you can pretty well understand credit and economic cycles. Early in the game of Monopoly®, people have a lot of cash and few hotels, and it pays to convert cash into hotels. Those who have more hotels make more money. Seeing this, people tend to convert as much cash as possible into property in order to profit from making other players give them cash. So as the game progresses, more hotels are acquired, which creates more need for cash (to pay the bills of landing on someone else's property with lots of hotels on it) at the same time as many folks have run down their cash to buy hotels. When they are caught needing cash, they are forced to sell their hotels at discounted prices. So early in the game, "property is king" and later in the game, "cash is king." Those who are best at playing the game understand how to hold the right mix of property and cash, as this right mix changes.*

If you can grasp this and understand the role of credit in driving demand and both the short-term debt cycle (aka business cycle) and longer-term debt-cycle, then you are already leaps and bounds ahead of any economist with a PhD attached to their name.

Dalio is great at breaking things down to their essentials or first principles. An example of this is how he looks at the drivers of various asset classes. This is called the quadrant approach, which he uses as a basis for his All-Weather fund.

The idea is that every asset class performs a certain way depending on the economic environment. There are two *primary* forces that comprise an economic environment. These are: inflation and growth. You combine these and you get four states: decreasing inflation, decreasing growth; decreasing inflation, increasing growth; increasing inflation, decreasing growth; increasing inflation, increasing growth.



> *In our view, there are many markets but just a few primary market forces, and these forces influence all of them. A market price is the discounted present value of future cash flows. Economic growth and inflation are the two most significant drivers of those cash flows, and discount rates and risk premiums determine how these cash flows are reflected in current prices. Given this, prices largely reflect discounted future economic scenarios, which are a combination of discounted growth, discounted inflation, risk premiums and discount rates. The magnitudes of price changes reflect shifts in these four forces.*
>
> *Bonds will perform best during times of disinflationary recession, stocks will perform best during periods of growth, and cash will be the most attractive when money is tight. Translation: All asset classes have environmental biases. They do well in certain environments and poorly in others.*
>
> *When I say uncorrelated asset classes, what I'm really doing is not using the classic measure of correlation, like stocks and bonds are 40% correlated. What I am instead really referring to us, do you know how they behave, and is it intrinsically going to behave alike or differently?*
>
> *The only way to achieve reliable diversification is to balance a portfolio based on the relationships of assets to their environmental drivers, rather than based on correlation assumptions, which are just fleeting byproducts of these relationships. To do this, we recognize that while asset classes offer a risk premium that is by and large the same once adjusting for risk, their inherent sensitivities to shifts in the economic environment are not the same. Therefore you can structure a portfolio of risk-adjusted asset classes so that their environmental sensitivities reliably offset one another, leaving the risk premium as the dominant driver of returns.*
>
> *Underperformance of a given asset class relative to its risk premium in a particular environment (e.g., nominal bonds in higher than expected inflation) will automatically be offset by the outperformance of another asset class with an opposing sensitivity to that environment (e.g., commodities), leaving the risk premium as the dominant source of returns, and producing a more stable overall portfolio return.*

The only free lunch in investing is diversification. But what is true diversification?

Many investors thought they were diversified in 2008 but quickly found out that was wrong when their asset correlations all went to one.

Recent beta and short-term backward looking correlations are a poor indicator of future correlations and risk. To truly diversify, you need to understand the principle drivers (inflation, growth) of the broader asset classes you hold and deduce the correlations (risk) from there.

As soon as you understand that, you can then apply what Dalio calls, “The Holy Grail of investing” (first paragraph via *Market Wizards*).

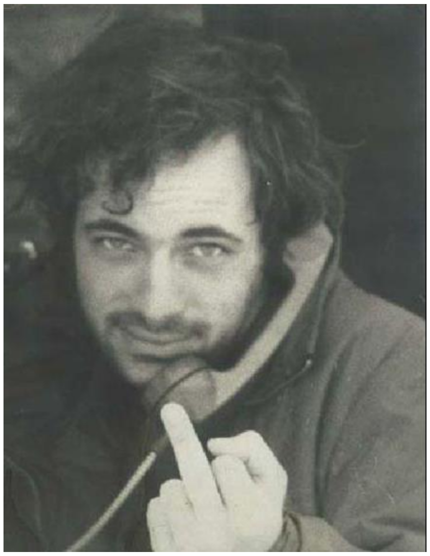
[Dalio walks over to the board and draws a diagram where the horizontal axis represents the number of investments and the vertical axis the standard deviation.] This is a chart that I teach people in the firm, which I call the Holy Grail of investing. [He then draws a curve that slopes down from left to right—that is, the greater the number of assets, the lower the standard deviation.] This chart shows how the volatility of the portfolio changes as you add assets. If you add assets that have a 0.60 correlation to the other assets, the risk will go down by about 15 percent as you add more assets, but that's about it, even if you add a thousand assets. If you run a long-only equity portfolio, you can diversify to a thousand stocks and it will only reduce the risk by about 15 percent, since the average stock has about a 0.60 correlation to another stock. If, however, you're combining assets that have an average of zero correlation, then by the time you diversify to only 15 assets, you can cut the volatility by 80 percent. Therefore, by holding uncorrelated assets, I can improve my return/risk ratio by a factor of five through diversification….I strive for approximately 100 different return streams that are roughly uncorrelated to each other. There are cross-correlations that enter into it, so the number works out to be less than 100, but it is well over 15.

So for example, if I had return streams that were 60% correlated, and I had a thousand of them, I would only reduce the risk by about 15%. And after 5 or 6, it's limited. SO there's a certain notion when approaching investing. What do I want? I need to have a certain structure. That can come in the form of alphas and betas. What is my risk neutral position? I'll say everybody in the room, they say what should I invest in? They don't start off, I think, with what is a neutral position. What represents a good neutral position, balance? For example, does gold represent a part of my portfolio? What should, if I had no view, what should the concentration in dollars be? What is a structural beta portfolio? And then how do I take a deviation from that beta portfolio? And how do I do that in an uncorrelated way, so that I can then maximize my return to risk? So in that first principle, what I'm saying is that if you follow that first principle and you get 15 good -- don't have to be great -- uncorrelated return streams, you'll improve your return to your risk by a factor of 5. That means 5 times the return for the same amount of risk. That's just a principle; that's a reality.

So that's the framework, the Machine, for not only how to view markets and economies but for how to attain everything you want in life, all via Ray Dalio.

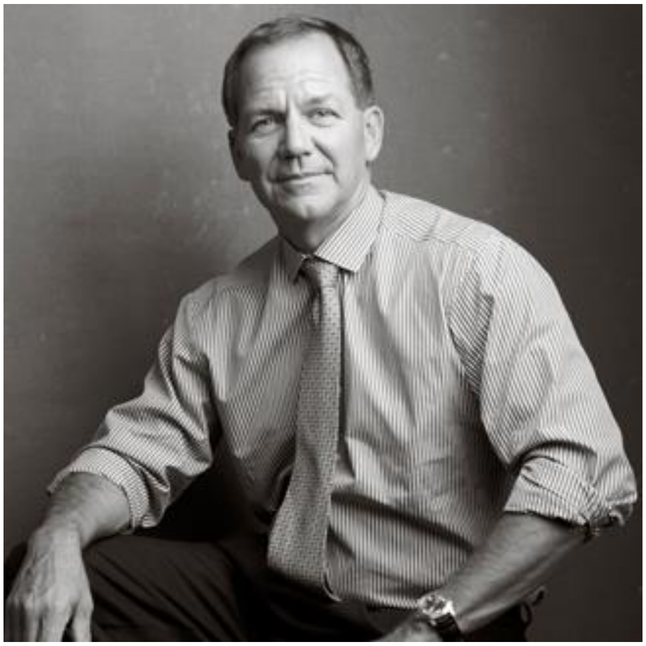
His thinking has had a profound impact on my own, as I hope it does with your thinking as well.

To end, I'll let younger Ray send us off…



Paul Tudor Jones: Never Lose…

From Jack Schwager's *Market Wizards:*



> *October 1987 was a devastating month for most investors as the world stock markets witnessed a collapse that rivaled 1929. That same month, the Tudor Futures Fund, managed by Paul Tudor Jones, registered an incredible 62 percent return. Jones has always been a maverick trader. His trading style is unique and his performance is uncorrelated with other money managers. Perhaps most important, he has done what many thought impossible: combine five consecutive, triple-digit return years with very low equity retracements. (I am fudging slightly; in 1986, Paul's fund realized only a 99.2 percent gain!)*
>
> *Jones has succeeded in every major venture he has tried. He started out in the business as a broker and in his second year grossed over $1 million in commissions. In fall 1980, Jones went to the New York Cotton Exchange as an independent floor trader. Again he was spectacularly successful, making millions during the next few years. His really impressive achievement though was not the magnitude of his winnings, but the consistency of his performance: During his three and a half years as a floor trader, he witnessed only one losing month.*

It's been 25 years since Paul Tudor Jones (PTJ) was featured in the original *Market Wizards*. He has since maintained his all-star track record. According to the New York Times, as of mid-2014, PTJ's flagship fund averaged long-term annual returns of around 19.5%. And what's even more impressive is that he didn't have a <u>single losing</u> year over those 25 consecutive years — a feat unheard of in the hedge fund industry.

There's much we can learn from this legendary fund manager, whose trading style resembles that of a street fighter and whose gut-instinct for market turns are unparalleled.

PTJ on the <u>most important</u> thing… "Don't lose money"

> *"...at the end of the day, the most important thing is how good are you at risk control. Ninety-percent of any great trader is going to be the risk control."*

PTJ has an aggressive, cut-throat trading style, which is necessary if you want to string together multiple 100%+ years like he did. But what's extraordinary about this record is the lack of drawdowns. It's something only a handful of traders have ever accomplished (ie, Druckenmiller, Soros, Brandt).

He achieved this by mastering risk-management and consistently chopping off that left tail. This is a key trait of **ALL** top traders and investors... and PTJ stands out as one of the best. He learned the critical importance of managing risk through the painful and indelible experience of trading and making mistakes.

- *Losing those stakes in my early 20s gave me a healthy dose of fear and respect for Mr. Market and hardwired me for some great money management tools.*

- *That was when I first decided I had to learn discipline and money management. It was a cathartic experience for me, in the sense that I went to the edge, questioned my very ability as a trader, and decided that I was not going to quit. I was determined to come back and fight. I decided that I was going to become very disciplined and businesslike about my trading.*

Author Brian McGill writes, "We are never taught more deeply and more truthfully than by pain." True words…

PTJ has mentioned that when hiring traders he prefers those who have blown up accounts and suffered the pain of large losses. These traders have had risk management seared into their very *being*. This is a trait that almost has to be learned through experience and can't be taught.

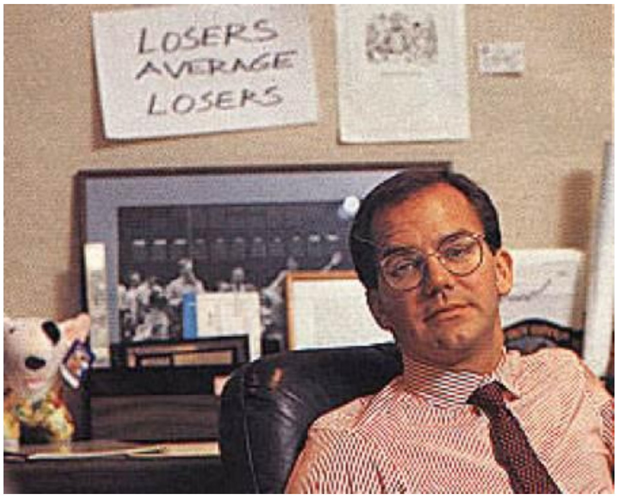
Side note: I remember reading the original Market Wizards book over a decade ago when I was as a green-behind-the-ears market punter. It seemed that every interview included a "Market Wizard" recounting their blown account from the early days and physical and emotional anguish that came with it. I thought to myself "wow, that sounds shitty. I'll just never do that so I don't have to experience something similar. Luckily, I'm an extremely levelheaded guy who doesn't get emotional over trading. I'll just stick to my risk management protocols and be fine."

Fast forward a couple of years, two blown out accounts and a lot of money up in flames later, and yours truly finally realized how naive (stupid, ignorant, arrogant etc) he'd been. One of the Market Wizards (don't remember the name) said something along the lines of "experiencing the pain of blowing up an account is a necessary stepping stone to learning how vital risk management is." I couldn't agree more. I emerged from the visceral and painful experiences of those big losses humbled and equipped with a maniacal focus on not losing money. Those early losses were important money spent on my trading tuition.

Like Seykota said, “The elements of good trading are: (1) cutting losses, (2) cutting losses, and (3) cutting losses. If you can follow these three rules, you may have a chance.” For some reason this is a platitude repeated by many, but understood by very few.

- *I think I am the single most conservative investor on earth in the sense that I absolutely hate losing money.*

- *There's no reason to take substantial amounts of financial risk ever, because you should always be able to find something where you can skew the reward risk relationship so greatly in your favor that you can take a variety of small investments with great reward risk opportunities that should give you minimum drawdown pain and maximum upside opportunities.*



- *Don’t ever let them get into your pocket — that means there’s no reason to leverage substantially.*

- *When I am trading poorly, I keep reducing my position size. That way, I will be trading my smallest position size when my trading is worst.*

- *I have very strong views of the long-run direction of all markets. I also have a very short-term horizon for pain.*

- *Everything gets destroyed a hundred times faster than it is built up. It takes one day to tear down something that might have taken ten years to build.*

On The Importance of Asymmetry And Macro

So much of successful trading consists of finding the right balance between risk management and betting big on the juiciest opportunities. This is one of the most difficult questions a trader is forced to constantly grapple with. There are no perfect answers.

Markets are fluid and dynamic. There will always be many unknowns. And because of this inherent complexity, a trader should always err on the side of capital preservation over profit maximization. It’s a lot easier to get steam rolled than it is to hit the cover off a fat pitch.

An important tool in rectifying the capital preservation/profit maximization dilemma is the understanding and implementation of asymmetry in trading.

Profitable trading is about finding and creating positive asymmetry. Positive asymmetry is when potential gains are multiples of potential losses. The greater the positive multiple, the greater the asymmetry. A trader should always be thinking in this fashion of potential risk weighted against potential reward (risk/reward).

A trader can find asymmetric opportunities through many approaches (ie, technical, fundamental, macro, sentiment etc) and then create more asymmetry through position sizing and risk/trade management. Finding and creating asymmetry is a central aspect of PTJ's approach.

- *[I'm looking for] 5:1 (risk /reward). Five to one means I'm risking one dollar to make five. What five to one does is allow you to have a hit ratio of 20%. I can actually be a complete imbecile. I can be wrong 80% of the time, and I'm still not going to lose.*

- *I'd say that my investment philosophy is that I don't take a lot of risk, I look for opportunities with tremendously skewed reward-risk opportunities.*

PTJ is a macro trader. Trading macro means different things to different people. To PTJ, it means he doesn't adhere to any single approach and is unconstrained in where he goes and what he trades. He also often takes a top-down approach when assessing markets. He simply uses whatever tool that works and makes him money.

- *I love trading macro. If trading is like chess, then macro is like three-dimensional chess. It is just hard to find a great macro trader.*

- *The secret to being successful from a trading perspective is to have an indefatigable and an undying and unquenchable thirst for information and knowledge. Because I think there are certain situations where you can absolutely understand what motivates every buyer and seller and have a pretty good picture of what's going to happen. And it just requires an enormous amount of grunt work and dedication to finding all possible bits of information.*

Market prices are the reflection of two forces: supply and demand. It's the goal of the trader to use the tools at his disposal to better understand the supply and demand situation of the asset he's trading.

- *I know from studying history that credit eventually kills all great societies. We have essentially taken out our American Express card and said we are going to have a great time.*

- *Maybe there are macroeconomic forces at work that are part of a larger super cycle that we don't have any control over. Perhaps we are simply responding to the same type of cycles that most advanced civilizations fell prey to, whether it was the Romans, sixteenth century Spain, eighteenth-century France, or nineteenth-century Britain.*

- *You look at every bear market and they've always basically occurred because of an uptick in inflation and an uptick in interest rates.*

Markets are driven by credit cycles. And because Central Banks control the cost of money (credit), they are the primary cause of bull and bear markets.

- *When trading macro, you never have a complete information set or information edge the way analysts can have when trading individual securities. It's a hell of a lot easier to get an information edge on one stock than it is on the S&P 500.*

- *When it comes to trading macro, you cannot rely solely on fundamentals; you have to be a tape reader, which is something of a lost art form.*

- *Certain people have a greater proclivity for [macro trading] because they don't have the need to feel intellectually superior to the crowd. It's a personality thing. But a lot of it is environmental. Many of the successful macro guys today, they're all kind of in my age range. They came from that period of crazy volatility, of the late '70s and early '80s, when the amount of fundamental information available on assets was so limited and the volatility so extreme that one had to be a technician. It's very hard to find a pure fundamentalist who's also a very successful macro trader because it is so hard to have a hit rate north of 50 percent. The exceptions are in trading the very front end of interest rate curves or in specializing in just a few commodities or assets.*

- *These days, there are many more deep intellectuals in the business, and that, coupled with the explosion of information on the internet, creates the illusion that there is an explanation for everything and that the primary task is simply to find that explanation.*

Many market participants — especially the "smart" ones — fail because they think they can understand every move. To them, it's more important to sound intelligent than it is to make money over the long-term. Academic economists who have a history of sounding smart but being wrong are great examples of this.

As a trader you have to know what you know and know what you don't know… and never get the two mixed up. Markets will never fail to surprise you. One of the most dangerous things in this game is uniformed conviction. Be humble, embrace your fallibility and know that it's impossible to *really* know the why in this game with anything close to absolute certainty.

Why it pays to be a "Slave to the Tape"

PTJ has an uncanny knack for reading the tape (price action) and getting a feel for where markets are going. A product no doubt of the era in which he came up, where information was scarce and the tape was the primary signal and information source. Since the market always knows more than you do, a trader has to respect price above all else.

- *The inability to read a tape and spot trends is also why so many in the relative value space who rely solely on fundamentals have been annihilated in the past decade. Markets have consistently experienced '100-year events' every five years.*

- *While I spend a significant amount of my time on analytics and collecting fundamental information, at the end of the day, I am a slave to the tape and proud of it.*

- *...at the end of the day, your job is to buy what goes up and to sell what goes down so really who gives a damn about PE's? If it's going up you're supposed to be long it. But there's no question that it's just easier for me to leverage with some degree of conviction the short side of some markets.*

- *I see the younger generation hampered by the need to understand and rationalize why something should go up or down. Usually, by the time that becomes self-evident, the move is already over. When I got into the business, there was so little information on fundamentals, and what little information one could get was largely imperfect. We learned just to go with the chart.*

- *...technical analysis is at the bottom of the study list for many of the younger generation, particularly since the skill often requires them to close their eyes and trust the price action.*

Livermore would say, “Your business with the tape is now — not tomorrow. The reason can wait. Buy you must act instantly or be left.” PTJ understands that truth and pays ultimate respect to price action as a result.

- *All the trades I have on are interrelated. I look at it in terms of what my equity is each morning. My goal is to finish each day with more than I started.*

- *Everyone says you get killed trying to pick tops and bottoms and you make all the money by catching the trends in the middle... I have often been missing the meat in the middle, but I have caught a lot of bottoms and tops.*

- *It's not that we had any unfair knowledge that other people didn't have, it is just that we did our homework. People just don't want to believe that anyone can break away from the crowd and rise above mediocrity.*

Evolution, Staying Frightened, and Emotional Detachment

The evolution of a trader generally follows the progression of moving from simplicity —> complexity —> informed simplicity. The goal is to build up your knowledge base, find what works, and strip yourself of what doesn’t. Da Vinci was right when he said “simplicity is the ultimate sophistication”. Many traders hide their ignorance with complex models, indicators, and theories filled with big words but of little value.

- *There's a fundamental information set that you acquire with regard to each particular asset class and then you overlay a whole host of technical indicators and that's how you make a decision.*

- *Tullis taught me about moving volume. When you are trading size, you have to get out when the market lets you out, not when you want to get out. He taught me that if you want to move a large position, you don't wait until the market is in new high or low ground because very little volume may trade there if it is a turning point.*

- *I consider myself a premier market opportunist. That means I develop an idea on the market and pursue it from a very low-risk standpoint until I have repeatedly been proven wrong, or until I change my viewpoint.*

- *When you get a range expansion, the market is sending you a very loud, clear signal that the market is getting ready to move in the direction of that expansion.*

- *...because of the complexity of defining interacting and changing market patterns, a good trader will usually be able to outperform a good system.*

- *It doesn't make any difference whether it's pork bellies or Yahoo. At the end of the day, it's all the same. You need to understand what factors you need to have at your disposal to develop a core competency to make a legitimate investment decision in that particular asset class.*

- *Now I spend my day trying to make myself as happy and relaxed as I can be. If I have positions going against me, I get right out; if they are going for me, I keep them.*

- *The idea that you can't beat the markets is a frightening prospect. That is why my guiding trading philosophy is playing great defense. If you make a good trade, don't think it is because you have some uncanny foresight. Always maintain your sense of confidence, but keep it in check.*

- *I think one of my strengths is that I view anything that has happened up to the present point in time as history. I really don't care about the mistake I made three seconds ago in the market. What I care about is what I am going to do from the next moment on.*

- *I try to avoid any emotional attachment to a market. I avoid letting my trading opinions be influenced by comments I may have made on the record about a market.*

- *[No loyalty to positions] is important because it gives you a wide open intellectual horizon to figure out what is really happening. It allows you to come in with a completely clean slate in choosing the correct forecast for that particular market.*

- *I know that to be successful, I have to be frightened. My biggest hits have always come after I have had a great period and I started to think that I knew something.*

- *When I think of long/short business, to me there's 5 ways to make money: 2 of those are you either play mean reversion, which is what a lot of long/short strategies do, or you can play momentum/trend, and that's typically what I do. We've seen cheap companies get cheaper many, many times. If something's going down, I want to be short it, and if something's going up, I want to be long it. The sweet spot is when you find something with a compelling valuation that is also just beginning to move up. That's every investor's dream.*

PTJ is a legendary trader because he's great at playing defense and neurotic about protecting his capital. He never pigeonholed himself into a single trading approach but instead uses a multitude of tools; adopting what works and tossing what doesn't. Through years of studying the tape he developed an instinctual feel for price action which allows him to spot turning points in markets and be aggressive at inflection points.

And above all else, even after obviously becoming one of the greatest, he's still maintained a deep sense of humility in approaching markets which has allowed him to remain mentally flexible and robust.

"Don't be a hero. Don't have an ego. Always question yourself and your ability. Don't ever feel that you are very good. The second you do, you are dead."

Stanley Druckenmiller: Betting Big

The "greatest money making machine in history", a man with "Jim Roger's analytical ability, George Soros' trading ability, and the stomach of a riverboat gambler" is how fund manager Scott Bessent describes Stanley Druckenmiller. That's high praise, but if you look at Druckenmiller's track record, you'll find it's well deserved.

Druck averaged over 30% returns the last three decades — impressive. But what's even more astonishing is the lack of volatility… the guy almost never loses.

He never had a *single* down year and only had five losing quarters out of 120 altogether! That's absolutely unheard of. And he did all of this in **size**. At his peak, Druck was running more than $20 billion and he was still managing to knock it out the park.

When you study Druckenmiller you get the sense that he was built in a laboratory, deep in a jungle somewhere, where he was put together piece by piece to create the perfect trader. Every character trait that makes up a good speculator, Druck possesses in spades… things like:

- Mental flexibility
- Independent thinking
- Extreme competitiveness
- Tireless inquisitiveness
- Deep self-awareness

Maybe he's a freak of nature or perhaps a secret Jesse Livermore / George Soros lovechild... or maybe he's just a relentlessly determined trader who's been on a lifelong path of mastery. Either way, it behooves us to study the thoughts and actions of one of the game's greatest.

On what moves stocks

In Jack Schwager's book *The New Market Wizards*, Druckenmiller said this in response to the question of how he evaluates stocks (emphasis is mine):

> *When I first started out, I did very thorough papers covering every aspect of a stock or industry. Before I could make the presentation to the stock selection committee, I first had to submit the paper to the research director. I particularly remember the time I gave*

> *him my paper on the banking industry. I felt very proud of my work. However, he read through it and said, "This is useless. What makes the stock go up and down?" That comment acted as a spur. Thereafter, I focused my analysis on seeking to identify the factors that were strongly correlated to a stock's price movement as opposed to looking at all the fundamentals.* ***Frankly, even today, many analysts still don't know what makes their particular stocks go up and down.***

The financial world is chock full of noise and nonsense. It's filled with smart people who don't know a damn thing about how the world *really* works. The financial system's incentive structure is set up so that as long as analysts sound smart and pretend like they know why stock xyz is going up, they get rewarded. This holds true for all the talking heads and "experts" except for those who actually trade real money. They either learn the game or get competed out.

Being one of those who compete in the arena, Druckenmiller was forced to learn early on what actually drives prices. This is what he found:

> *Earnings don't move the overall market; it's the Federal Reserve Board… focus on the central banks and focus on the movement of liquidity… most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets.*

Liquidity is the expansion and contraction of money, specifically credit. As we've explained, it's the biggest variable that drives demand in an economy and it's why keeping a constant eye on the Fed is so important.

This is not to say that things like sales and earning don't matter. They're still very important at the singular stock level. Here's Druckenmiller again (emphasis mine):

> *Very often the key factor is related to earnings. This is particularly true of the bank stocks. Chemical stocks, however, behave quite differently. In this industry, the key factor seems to be capacity. The ideal time to buy the chemical stocks is after a lot of capacity has left the industry and there's a catalyst that you believe will trigger an increase in demand. Conversely, the ideal time to sell these stocks is when there are lots of announcements for new plants, not when the earnings turn down. The reason for this behavioral pattern is that expansion plans mean that earnings will go down in two to three years,* ***and the stock market tends to anticipate such developments.***

The market is a future discounting machine; meaning earnings matter for a stock, but more so in the future than in the past.

Most market participants take recent earnings and just extrapolate them into the future. They fail to *really* look at the mechanism that drives the bottom line for a particular company or sector. The key to being a good trader is to identify the factor(s) that will drive earnings going forward, not what drove them in the past.

Druckenmiller said in a recent interview that his "job for 30 years was to anticipate changes in the economic trends that were not expected by others, and, therefore not yet reflected in security prices." **Focus on the future, not the past.**

Another thing that sets Druck apart is his willingness to use anything that works; as in any style or tool to find good trades and manage them.

- *Another discipline I learned that helped me determine whether a stock would go up or down is technical analysis. Drelles was very technically oriented, and I was probably more receptive to technical analysis than anyone else in the department. Even though Drelles was the boss, a lot of people thought he was a kook because of all the chart books he kept. However, I found that technical analysis could be very effective.*

- *I never use valuation to time the market. I use liquidity considerations and technical analysis for timing. Valuation only tells me how far the market can go once a catalyst enters the picture to change the market direction.*

Druckenmiller employs a confluence of approaches (fundamental, macro, technical and sentiment) to broaden his view of the battlefield.

How to make outsized returns

Druckenmiller throws conventional wisdom out the window. Instead of placing a lot of small diversified bets, he practices what we call the "Big Bet" philosophy, which consists of deploying a few large concentrated bets.

Here's Druckenmiller on using the big bet philosophy (emphasis mine):

> *The first thing I heard when I got in the business, not from my mentor, was bulls make money, bears make money, and pigs get slaughtered. I'm here to tell you I was a pig.* ***And I strongly believe the only way to make long-term returns in our business that are superior is by being a pig. I think diversification and all the stuff they're teaching at business school today is probably the most misguided concept everywhere.*** *And if you look at all the great investors that are as different as Warren Buffett, Carl Icahn, Ken Langone, they tend to be very, very concentrated bets. They see something, they bet it, and they bet the ranch on it. And that's kind of the way my philosophy evolved, which was if you see – only maybe one or two times a year do you see something that really, really excites you…* ***The***

> ***mistake I'd say 98% of money managers and individuals make is they feel like they got to be playing in a bunch of stuff. And if you really see it, put all your eggs in one basket and then watch the basket very carefully.***

A lot of wisdom in that paragraph. To earn superior long-term returns you have to be willing to bet big when your conviction is high. And the corollary is that you need to protect your capital by not wasting it on a "bunch of stuff" you don't have much conviction on.

This reminds me of what Seth Klarman wrote in his book *Margin of Safety*:

> ***Avoiding loss should be the primary goal of every investor.*** *This does not mean that investors should never incur the risk of any loss at all. Rather "don't lose money" means that over several years an investment portfolio should not be exposed to appreciable loss of capital. While no one wishes to incur losses, you couldn't prove it from an examination of the behavior of most investors and speculators.* ***The speculative urge that lies within most of us is strong; the prospect of free lunch can be compelling, especially when others have already seemingly partaken.*** *It can be hard to concentrate on losses when others are greedily reaching for gains and your broker is on the phone offering shares in the latest "hot" initial public offering.* ***Yet the avoidance of loss is the surest way to ensure a profitable outcome.***

You need to keep your powder dry so that when the stars align you can go for the jugular and turkey neck that son of a gun.

The importance of striking when the iron is hot is something Druckenmiller learned while trading for George Soros.

> *I've learned many things from [George Soros], but perhaps the most significant is that it's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong. The few times that Soros has ever criticized me was when I was really right on a market and didn't maximize the opportunity.*

An intense focus on capital preservation coupled with a big bet approach is the barbell philosophy used by many of the greats.

Keeping your losses small and pushing your winners hard is the name of the game in profitable speculation.

The fund washout we're seeing today is not *just* because of the glut of mediocrity in the money management space, but also because even decent managers are scared to take the necessary risks to have big return years. They manage too much to the benchmark and are too short-term focused. That's a recipe for average performance. Here's Druck on how it should be done:

> *Many managers, once they're up 30 or 40 percent, will book their year [i.e., trade very cautiously for the remainder of the year so as not to jeopardize the very good return that has already been realized]. The way to attain truly superior long-term returns is to grind it out until you're up 30 or 40 percent, and then if you have the conviction, go for a 100 percent year. If you can put together a few near-100 percent years and avoid down years, then you can achieve really outstanding long-term returns.*

Once you've earned the right to be aggressive and can bet with the house's money (profits), you should plunge hard when that high conviction trade arises and push for outsized returns.

The trader's mindset and handling losses

According to Druck, to be a winning trader you need to be "decisive, open-minded, flexible and competitive".

The day before the crash in 1987, Druckenmiller switched from net short to 130% long because he thought the selloff was done. He saw the market bumping up against significant support. But through the course of the day he realized that he made a terrible mistake. The next day he flipped his book and got short the market and actually made money. You see this type of mental flexibility in all the greatest traders. And Druckenmiller is one trader that epitomizes it perhaps better than anybody else.

The practice of having "strong opinions, weakly held" is difficult but paramount to success.

In order to attain that level of mental flexibility, you need to learn to detach ego from your immediate trade outcomes. If you allow losses to affect your judgement, you'll inevitably make bigger mistakes. Druckenmiller learned this lesson early on from Soros.

> *Soros is the best loss taker I've ever seen. He doesn't care whether he wins or loses on a trade. If a trade doesn't work, he's confident enough about his ability to win on other trades that he can easily walk away from the position. There are a lot of shoes on the shelf; wear only the ones that fit.* ***If you're extremely confident, taking a loss doesn't bother you.***

One of the best parts about this game is that as long as you stay alive (protect your capital) you can always make another trade. Druckenmiller said the "wonderful thing about our business is that it's liquid, and you can wipe the slate clean on any day. As long as I'm in control of the situation — that is, as long as I can cover my positions — there's no reason to be nervous."

I remember watching Charlie Rose interview Druckenmiller a few years ago. Charlie asked him why, after all these years, and with all the money he's made, does he still put in 60-hour weeks trading? Druck responded (and I'm paraphrasing here) "because I have to… I love the game and I love winning, the money isn't even important."

To get to Druck's level, you have to trade because that's just what you do. It's what you live for.

George Soros: Philosophy In Motion

Remember the scene from the 90's classic, *The Sandlot*, where "Smalls" loses his father's Babe Ruth autographed baseball to "The Beast" and the other kids question him in disbelief, saying:

Smalls: *I was gonna put the ball back.*

Squints: *But it was signed by Babe Ruth!*

Smalls: *Yeah, you keep telling me that! Who is she?*

Ham Porter: *WHAT? WHAT?*

Kenny: *The sultan of swat!*

Bertram: *The king of crash!*

Timmy: *The colossus of clout!*

Tommy: *The colossus of clout!*

All: *BABE RUTH!*

Ham Porter: *THE GREAT BAMBINO!*

Smalls: *Oh my god! You mean that's the same guy?*

All: *YES!*

Benny Rodriguez: *Smalls, Babe Ruth is the greatest baseball player that ever lived. People say he was less than a god but more than a man. You know, like Hercules or something. That ball you just aced to The Beast is worth, well, more than your whole life.*

Smalls: *[Falls to the ground and clutches his stomach, groaning] I don't feel so good.*

All: *[Fanning Scott with their caps] Give him air, give him air.*

If there's a trader equivalent to baseball's greatest; a sultan of swat, a colossus of clout, or a king of crash, then it's undoubtedly George Soros, the GREAT BAMBINO of markets.

Soros founded and ran the legendary Quantum Fund which compounded at 32%+ between 1969 and 2000 (over 30 years). A $1000 investment in the Quantum Fund at inception would have been worth over *$4 million* by 2000. This makes Soros arguably one of the most successful hedge fund managers of all time. He also worked with and mentored other trading greats such as Stanley Druckenmiller and Jim Rogers.

The man is known for single handedly taking down the Bank of England, in a 1992 bet against the pound, that netted over $1 billion in the course of a *single* day. He seemed to play the markets on a whole other level than his peers. There are stories of him correctly flipping huge positions because of a "back ache" that made him sense trouble.

Soros retired in 2011 from managing outside money so he could focus on trading his own vast fortune, estimated to be over $25 billion. Even in his 80's, he continues to kill it as well as train some of the best managers who go on to start their own successful hedge funds.

Needless to say, the Sultan of Swat knows a thing or two about markets. Here's some of his words of wisdom:

Trading, Bubbles and Markets

- *It's not whether you're right or wrong that's important, but how much money you make when you're right, and how much you lose when you're wrong.*

- *My approach works not by making valid predictions, but by allowing me to correct false ones.*

- *Typically bubbles have an asymmetric shape. The boom is long and slow to start. It accelerates gradually until it flattens out again during the twilight period. The bust is short and steep because it involves the forced liquidation of unsound positions. Disillusionment turns into panic, reaching its climax in a financial crisis.*

- *Every bubble has two components: an underlying trend that prevails in reality and a misconception relating to that trend. When a positive feedback develops between the trend and the misconception, a boom-bust process is set in motion. The process is liable to be tested by negative feedback along the way, and if it is strong enough to survive these tests, both the trend and the misconception will be reinforced.*

- *When the California residential home market collapsed, the market thought the company might go broke, but it survived the test and we made a fortune. That is when I made the rule that one should own stocks when they have successfully passed a difficult test, but one should avoid them during the test — something that is easier said than done.*

- *A positive feedback is self-reinforcing. It cannot go on forever because eventually, market prices would become so far removed from reality that market participants would* *have to recognize them as unrealistic. When that tipping point is reached, the process becomes self-reinforcing in the opposite direction.*

- *Usually some error in the act of valuation is involved. The most common error is a failure to recognize that a so-called fundamental value is not really independent of the act of valuation. That was the case in the conglomerate boom, where per-share earnings growth could be manufactured by acquisitions, and also in the international lending boom where the lending activities of the banks helped improve the debt ratios that banks used to guide them in their lending activity.*

- *I look for conditions of disequilibrium. They send out certain signals that activate me. So my decisions are really made using a combination of theory and instinct. If you like, you may call it intuition.*

- *I watch out for telltale signs that a trend may be exhausted. Then I disengage from the herd and look for a different investment thesis. Or, if I think the trend has been carried to excess, I may probe going against it.*

- *I am particularly keen on investment theses that the market is reluctant to accept. These are usually the strongest.*

- *It goes to show that when you are confused it is best to do nothing. You are just going for a random walk and that is when you are liable to get mugged because you don't have staying power. You are likely to be faked out by some stray fluctuation because you lack the courage of your convictions.*

- *At any moment of time there are myriads of feedback loops at work, some of which are positive, others negative. They interact with each other, producing the irregular price patterns that prevail most of the time; but on the rare occasions that bubbles develop to their full potential they tend to overshadow all other influences.*

- *My interpretation of financial markets differs from the prevailing paradigm in many ways. I emphasize the role of misunderstandings and misconceptions in shaping the course of history. And I treat bubbles as largely unpredictable. The direction and its eventual reversal are predictable; the magnitude and direction of the various phases is not.*

- *Markets tend to move in fits and starts, adopting a thesis and then abandoning it. We try to catch them if we can, but if we can't, we are better off not trying.*

- *I was prepared for a regime change, whereas other people were acting within a prevailing regime. And that is where I think my awareness that conditions can undergo revolutionary change was useful.*

- *Most of the time we are punished if we go against the trend. Only at inflection points are we rewarded.*

- *The whole thrust of my approach is that the course of events is indeterminate.*

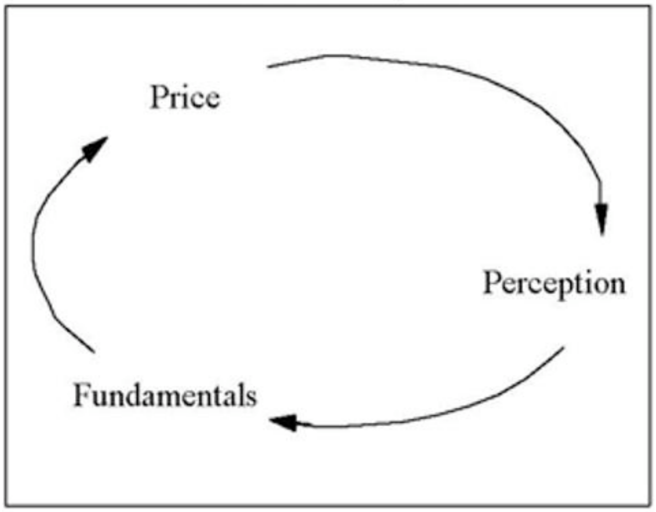
- *Being so critical, I am often considered a contrarian. But I am very cautious about going against the herd; I am liable to be trampled on... Most of the time I am a trend follower, but all the time I am aware that I am a member of the herd and I am on the lookout for inflection points.*

- *The market is a mathematical hypothesis. The best solutions to it are the elegant and the Simple.*

- *When you're sure you are right, no trade is too big.*

On His Theory of Reflexivity

Reflexivity Creates Virtuous and Vicious Cycles



- *Reflexivity sets up a feedback loop between market valuations and the so-called fundamentals which are being valued. The feedback can be either positive or negative. As a student of economics, I found it strange that classical economic theory, particularly the theory of perfect competition, should assume perfect knowledge. I was also rather weak in mathematics, so I preferred to question the assumptions rather than to study the equations based on them. I cogitated and concluded that economics theory is based on false premises. That is how I developed my theory of reflexivity, which recognizes a two way interaction between thinking and reality.*

- *The reflexive nature of human relations is so obvious that the question I would like to ask is, why has reflexivity not been properly recognized? Why, for instance, did economic theory deliberately ignore it? [And the answer is because] it cannot be reconciled with the goals of analytical science, which is to provide determinate predictions and explanations. Reflexivity throws a monkey-wrench into the works by introducing an element of uncertainty.*

- *Volatility is greatest at turning points, and diminishes as a [new] trend is established. Bubbles are not the only manifestations of reflexivity, but they are the most spectacular.*

- *I propose that we need three categories — [true, false, and reflexive](). The truth value of reflexive statements is indeterminate. It is possible to find other statements with an indeterminate truth value, but we can live without them. We cannot live without reflexive statements. I hardly need to emphasize the profound significance of this proposition. Nothing is more fundamental to our thinking than our concept of truth.*

- *If a self-reinforcing process goes on long enough it must eventually become unsustainable because either the gap between thinking and reality becomes too wide or the participant's bias becomes too pronounced. Hence, reflexive processes that become historically significant tend to follow an initially self-reinforcing, but eventually self-defeating, pattern. That is what I call the boom/bust sequence.*

- *Economics theory tried to imitate physics. Classical economists took Newton as their model — forgetting that Newton lost a fortune in the South Sea Bubble. The only way they could imitate physics was by eliminating reflexivity from their subject. Hence the assumption of perfect knowledge, which was later amended to perfect information.*

Regarding Philosophy and Knowledge

- *What is imperfect can be improved. Accepting the uncertainties connected with our fallibility opens up the vista for infinite improvement.*

- *I used to do a lot of philosophical speculation as a young man. I wasted a large part of my youth regurgitating certain ideas. Then I discovered that one can learn a great deal more through action than through contemplation. So I became an active thinker where my thinking played an important role in deciding what actions to take and my actions play an important role in improving my thinking. This two-way interaction between thinking and action became the hallmark of my philosophy and the hallmark of my life.*

- *I content that taking fallibility as the starting point makes my conceptual framework more realistic. But at a price: the idea that laws or models of universal validity can predict the future must be abandoned.*

- *Financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. This is the principle of fallibility. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times it is quite pronounced.*

- *Economic theory needs to be fundamentally reconsidered. There is an element of uncertainty in economic processes that has been largely left unaccounted for... We must take a radically different view of the role that thinking plays in shaping events.*

- *If we accept that our understanding is inherently imperfect, we can build a value system on that insight. That is what I have done with my belief in my own fallibility.*

- *It seems that we need to recognize more than two categories — true and false. The logical positivists claimed that statements which are not true or false are meaningless. I thoroughly disagree. Theories that can affect the subject matter to which they refer are the opposite of meaningless. They can change the world. They exemplify the active role that thinking can play in shaping reality. We need to adjust our concept of truth to account for them.*

On Risk Taking, Forming Hypothesis and Being Wrong

- *I work with hypotheses. I form a thesis about the anticipated sequence of events and then I compare the actual course of events with my thesis; that gives me a criterion by which I can evaluate my hypothesis.*

- *The prevailing wisdom is that markets are always right. I take the opposite position. I assume that markets are always wrong. Even if my assumption is occasionally wrong, I use it as a working hypothesis.*

- *Risk taking is painful. Either you are willing to bear the pain yourself or you try to pass it on to others. Anyone who is in a risk taking business but cannot face the consequences is no good.*

- *There is nothing like danger to focus the mind, and I do need the excitement connected with taking risks in order to think clearly. It is an essential part of my thinking ability. Risk taking is, to me, an essential ingredient in thinking clearly.*

- *As an investor, I find statistical probability of limited value; what matters is what happens in a particular case. The same applies with even greater force to historic events. I cannot make reliable predictions about them; all I can do is formulate scenarios. I can then compare the actual course of events with the hypothetical ones. Such hypotheses have no scientific validity, but they have considerable practical utility. They provide a basis for real-life decisions.*

- *The generally accepted theory is that the financial markets tend toward equilibrium and, on the whole, discount the future correctly. I operate using a different theory, according to which financial markets cannot possibly discount the future correctly because they do not merely discount the future; they help to shape it.*

- *To others, being wrong is a source of shame; to me, recognizing my mistakes is a source of pride. Once we realize that imperfect understanding is the human condition, there is no shame in being wrong, only in failing to correct our mistakes.*

- *I am outside. I am a thinking participant and thinking means putting yourself outside the subject you think about. Perhaps it comes easier to me than to many others because I* *have a very abstract mind and I actually enjoy looking at things, including myself, from the Outside.*

- *[The danger in taking risks] stimulates me. But don't misunderstand what I am saying: I don't like danger; I like to avoid it. That is what makes my juices flow. I am good at riding the tide, but not the ripples of a swimming pool.*

- *I would put it this way: I do not play according to a given set of rules; I look for changes in the rules of the game.*

- *I'm only rich because I know when I'm wrong... I basically have survived by recognizing my mistakes.*

Economic Theory

- *Economic history is a never-ending series of episodes based on falsehoods and lies, not truths. It represents the path to big money. The object is to recognize the trend whose premise is false, ride that trend, and step off before it is discredited.*

- *I am not knocking economics; I think it is a very elegant theoretical construct. I do question its applicability to the real world; and I question whether it survives testing in the financial markets. I believe that the performance of Quantum Fund alone falsifies the random walk theory.*

- *There are two kinds of disequilibrium: static disequilibrium, where both the prevailing dogma and the prevailing social conditions are rigidly fixed but quite far removed from each other; and dynamic disequilibrium, where both the real world and the participant's views are changing so rapidly that they cannot help but be far apart.*

- *Economics is a social science and there is a fundamental difference between the natural and social sciences. Social phenomena have thinking participants who base their decisions on imperfect knowledge. That is what economic theory has tried to ignore.*

- *If you consider our position as human beings trying to understand the world in which we live, you will find that we cannot confine our thinking to subjects that are independent of our thinking. We must make decisions about our lives and in order to do so we must hold views that do not qualify as knowledge, whether we recognize this or not. We must have recourse to beliefs. That is the human condition.*

- *Natural science deals with events that occur independently of what anybody thinks about them; therefore, it can treat events as a succession of facts. When events have thinking participants, the chain of causation does not lead directly from one set of facts to the next; insofar as the participant's thinking plays a role, it leads from facts to perceptions, from perceptions to decisions and from decisions to the next set of facts. There is also the direct link between one set of facts and the next which is characteristic of all natural phenomena. But the more circuitous link cannot be left out of account without introducing a distortion. The distortion is negligible when people's thinking is close to reality: it becomes significant when perception and reality are far apart.*

- *The market mechanism is better than other arrangements only because it provides feedback and allows mistakes to be corrected. This is the equivalent of Churchill's dictum about democracy: It is the worst system, except all the others.*

- *Ever since the Crash of 2008 there has been a widespread recognition, both among economists and the general public, that economic theory has failed. But there is no similar consensus... on the nature and implications of that failure... I believe that the failure is more profound than generally recognized. It goes back to the foundations of economic theory.*

- *Economics tried to model itself on Newtonian physics. It sought to establish universally and timelessly valid laws that govern reality. But economics is a social science and there is a fundamental difference between the natural and social sciences. Social phenomena have thinking participants who base their decisions on imperfect knowledge. That is what economic theory has tried to ignore.*

- *Classical economic theory assumes that market participants act on the basis of perfect knowledge. That assumption is false. The participant's perceptions influence the market in which they participate, but the market action also influences the participant's perceptions. They cannot obtain perfect knowledge of the market because their thinking is always affecting the market and the market is affecting their thinking.*

- *When speculators profit, the authorities have failed in some way or another. But they don't like to admit failure; they would rather call for speculators to be hung from lampposts than to engage in a little bit of soul-searching to see what they did wrong.*

- *I am not well qualified to criticize the theory of rational expectations and the efficient market hypothesis because as a market participant I considered them so unrealistic that I never bothered to study them.*

When Soros was at the height of his game he was so in tune with markets that he seemed to effortlessly pull out profits as he managed his capital like a well-honed conductor. During this time he said "I stood back and looked at myself with awe: I saw a perfectly honed machine." A "perfectly honed machine" indeed. Study and practice these tips and work on honing your machine.

Michael Marcus: The Trading Trifecta

Michael Marcus turned $30,000 into $80 million over a 20 year period — not too shabby.

But what many don't know about Marcus is that he was also part of what has to be the most famous mentor/trader lineage in trading history. The names read like a trader hall of fame inductee list.

The lineage began with Amos Hostetter, Founder of Commodity Corp and mentor to Ed Seykota. Seykota then trained Marcus whom in turn mentored Bruce Kovner.

That's like if Jerry West had trained Kareem Abdul-Jabbar who then taught Michael Jordan whom in turn mentored Stephen Curry.

Needless to say, whatever knowledge they were teaching one another is worth knowing.

On Having the Proper Mindset

- *I think that, in the end, losing begets losing. When you start losing, it touches off negative elements in your psychology; it leads to pessimism.*

- *I am very open-minded. I am willing to take in information that is difficult to accept emotionally, but which I still recognize to be true.*

- *Gut feel is very important. I don't know of any great professional trader that doesn't have it. Being a successful trader also takes courage: the courage to try, the courage to fail, the courage to succeed, and the courage to keep on going when the going gets tough.*

- *I would sometimes think that maybe I ought to stop trading because it was very painful to keep losing. In 'Fiddler on the Roof,' there is a scene where the lead looks up and talks to God. I would look up and say, 'Am I really that stupid?' And I seemed to hear a clear answer saying, 'No, you are not stupid. You just have to keep at it.' So I did.*

- *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.*

The Importance of Risk Management

- *At key intraday chart points, I could take much larger positions than I could afford to hold, and if it didn't work immediately, I would get out quickly. For example, at a critical intraday point, I would take a twenty-contract position, instead of the three to five contracts I could afford to hold, using an extremely close stop. The market either took off and ran, or I was out.*

- *If you become unsure about a position, and you don't know what to do, just get out. You can always come back in. When in doubt, get out and get a good night's sleep. I've done that lots of times and the next day everything was clear.*

- *My trading in those days was a little bit like being a surfer. I was trying to hit the crest of the wave just at the right moment. But if it didn't work, I just got out. I was getting a shot at making several hundred points and hardly risking anything. I later used that surfing technique as a desk trader.*

- *Perhaps the most important rule is to hold on to your winners and cut your losers. Both are equally important. If you don't stay with your winners, you are not going to be able to pay for the losers.*

The Philosophy Behind His Trading

- *Every trader has strengths and weaknesses. Some are good holders of winners, but may hold their losers a little too long. Others may cut their winners a little short, but are quick to take their losses. As long as you stick to your own style, you get the good and bad in your own approach.*

- *I think to be in the upper echelon of successful traders requires an innate skill, a gift. It's just like being a great violinist. But to be a competent trader and make money is a skill you can learn.*

- *In the final analysis, you need to have the courage to hold the position and take the risk. You need to be aware that the world is very sophisticated and always ask yourself: 'How many people are left to act on this particular idea?' You have to consider whether the market has already discounted your idea.*

- *I look for confirmation from the chart, the fundamentals, and the market action. I think you can trade anything in the world that way.*

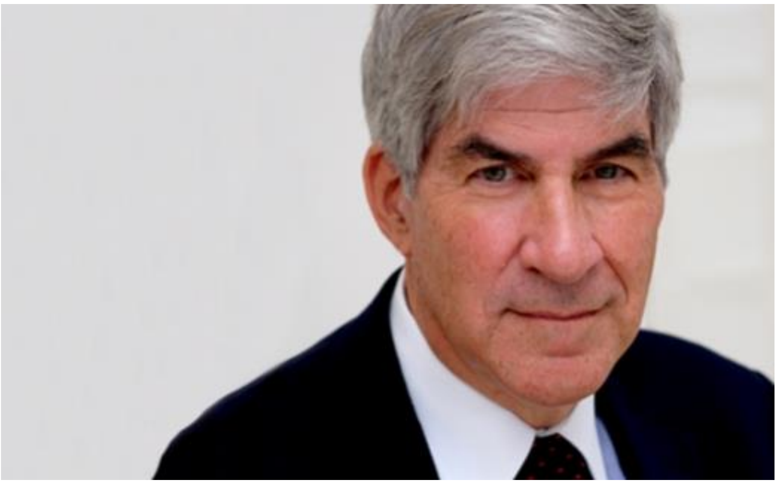
- *Comm. Corp. taught me to see the signal, like the signal, follow the signal. If you follow your system /methodology then over time your edge will kick-in and you'll end up ahead.*

The most important thing I've learned from Michael Marcus is to wait for the perfect setup. As he explained:

> *The best trades are the ones in which you have all three things going for you: fundamentals, technicals, and market tone. First, the fundamentals should suggest that there is an imbalance of supply and demand, which could result in a major move. Second, the chart must show that the market is moving in the direction that the fundamentals suggest. Third, when news comes out, the market should act in a way that reflects the right psychological tone.*

Fundamentals, technicals, and sentiment/macro. The most lucrative market opportunities are born when these three factors line up. This is what we call the Marcus Trifecta. And it's what we used as a basis for creating our own *Fusion Analysis Approach* to analyzing markets at Macro Ops. You can read all about it here.

Bruce Kovner: Anything Is Possible



Bruce Kovner retired in 2011 from Caxton Associates, the hedge fund he founded and ran for 28 years.

Over that time the fund returned an average of 21% a year since its inception. In comparison, the SPX averaged just 11%. Kovner had only one losing year (in 94’). Before Caxton, while trading at the famous Commodities Corp, he averaged close to 90% over 10 years. Impressive numbers by any measure.

As Michael Marcus’ disciple, Kovner comes from the tremendous Commodities Corp. trading lineage we mentioned earlier. There’s a lot we can learn from this Market Wizard.

Having the Necessary Vision

- *I’m not sure one can really define why some traders make it, while others do not. For myself, I can think of two important elements. First, I have the ability to imagine configurations of the world different from today and really believe it can happen. I can imagine that soybean prices can double or that the dollar can fall to 100 yen. Second, I stay rational and disciplined under pressure.*

- *What I am really looking for is a consensus the market is not confirming. I like to know that there are a lot of people who are going to be wrong.*

- *One of the jobs of a good trader is to imagine alternative scenarios. I try to form many different mental pictures of what the world should be like and wait for one of them to be confirmed. You keep trying them on one at at a time. Inevitably, most of these pictures will turn out to be wrong — that is, only a few elements of the picture may prove correct. But then, all of a sudden, you will find that in one picture, nine out of ten elements click. That scenario then becomes your image of the world reality.*

The Importance of Risk Management

- *The first rule of trading — there are probably many first rules — is don't get caught in a situation in which you can lose a great deal of money for reasons you don't understand.*

- *I would say that risk management is the most important thing to be well understood. Under trade, under trade, under trade is my second piece of advice. Whatever you think your position ought to be, cut it at least in half.*

- *Through bitter experience, I have learned that a mistake in position correlation is the root of some of the most serious problems in trading. If you have eight highly correlated positions, then you are really trading one position that is eight times as large.*

- *Whenever I enter a position, I have a predetermined stop. That is the only way I can sleep. I know where I'm getting out before I get in. The position size on a trade is determined by the stop, and the stop is determined on a technical basis.*

- *My experience with novice traders is that they trade three to five times too big. They are taking 5 to 10 percent risks on a trade when they should be taking 1 to 2 percent risks.*

- *I never think about stop vulnerability, because the point about a technical barrier — and I've studied the technical aspects of the market for a long time — is that the market shouldn't go there if you're right.*

- *The only thing that disturbs me is poor money management. Every so often, I take a loss that is significantly too large. But I never had a lot of difficulty with the process of losing money, as long as losses were the outcome of sound trading techniques.*

- *A common mistake is to think of the market as a personal nemesis. The market, of course, is totally impersonal; it doesn't care whether you make money or not.*

- *Whenever a trader says 'I wish,' or 'I hope,' he is engaging in a destructive way of thinking because it takes attention away from the diagnostic process.*

A Trader's Mindset

- *To this day, when something happens to disturb my emotional equilibrium and my sense of what the world is like, I close out all positions related to that event.*

- *(On Michael Marcus) He also taught me one other thing that is absolutely critical: You have to be willing to make mistakes regularly; there is nothing wrong with it. Michael taught me about making your best judgment, being wrong, making your next best judgment, being wrong, making your third best judgment, and then doubling your money.*

- *The emotional burden of trading is substantial; on any given day, I could lose millions of dollars. If you personalize these losses, you can't trade.*

- *Successful traders are strong, independent, and contrary in the extreme. They are able to take positions others are unwilling to take. They are disciplined enough to take the right size positions. A greedy trader always blows out.*

The Importance of Macro

- *I almost always trade on a market view; I don't trade simply on technical information. I use technical analysis a great deal and it is terrific, but I can't hold a position unless I understand why the market should move.*

- *There are well-informed traders who know much more than I do. I simply put things together… The market usually leads because there are people who know more than you do.*

Mastering Price Action

- *For me, technical analysis is like a thermometer. Fundamentalists who say they are not going to pay any attention to the charts are like a doctor who says he's not going to take a patient's temperature. But, of course, that would be sheer folly. If you are a responsible participant in the market, you always want to know where the market is — whether it is hot and excitable, or cold and stagnant. You want to know everything you can about the market to give you an edge.*

- *The principle characteristic of a bear market is very sharp down movements followed by quick retracements... In a bear market, you have to use sharp counter-trend rallies to enter positions.*

- *Technical analysis, I think, has a great deal that is right and a great deal that is mumbo jumbo… There is a great deal of hype attached to technical analysis by some technicians who claim that it predicts the future. Technical analysis tracks the past; it does not predict the future. You have to use your own intelligence to draw conclusions about what the past activity of some traders may say about the future activity of other traders.*

- *Technical analysis reflects the voice of the entire marketplace and, therefore, does pick up unusual behavior. By definition, anything that creates a new chart pattern is something unusual. It is very important for me to study the details of price action to see if I can observe something about how everybody is voting. Studying the charts is absolutely critical and alerts me to existing disequilibria and potential changes.*

Trading and The Heisenberg Principle

- *The general rule is: the less observed, the better the trade.*

- *The Heisenberg principle in physics provides an analogy for the markets. If something is closely observed, the odds are it is going to be altered in the process.*

- *The more a price pattern is observed by speculators, the more prone you are to have false signals. The more a market is the product of non-speculative activity, the greater the significance of technical breakouts.*

- *As an alternative approach, one of the traders I know does very well in the stock index markets by trying to figure out how the stock market can hurt the most traders. It seems to work for him.*

- *As a trader who has seen a great deal and been in a lot of markets, there is nothing disconcerting to me about a price move out of a trading range that nobody understands.*

- *Tight congestions in which a breakout occurs for reasons that nobody understands are usually good risk/reward trades.*

The most amazing part of Kovner's story isn't his stellar returns… but that he used to be a full-time cab driver! He came from nothing and used the markets to become a billionaire and trading legend. They key for Kovner was realizing that he actually *had* the ability to succeed in the markets. Here's how he described it:

> *Michael [Marcus] taught me one thing that was incredibly important… He taught me that you could make a million dollars. He showed me that if you applied yourself, great things could happen. It is very easy to miss the point that you really can do it. He showed me that if you take a position and use discipline, you can actually make it.*

As I said in the very beginning of this report, there's nothing special to how these trading greats achieved their success. There's no secret. It just comes down to having some base knowledge and then adding in a hell of a lotta hard work.

There's no reason why you can't be the next trading great.

That being said… there *is* one surefire way to speed up your evolution. And that's by having an elite team help you along the way.

Kovner came up in Commodities Corp (CC) where he was surrounded by some of the best traders who ever lived, including Paul Tudor Jones and Michael Marcus, two other trading greats covered in this report.

The CC environment allowed Kovner to flourish.

He was exposed to a number of different ideas, trading styles, theories and so on. Everyone at CC was also extremely motivated and working towards the same goal of mastering the markets. This created a multitude of developmental feedback loops where iron could sharpen iron and rapid evolution could be spawned.

I always wanted to work at Commodities Corp. I dreamed of training with and learning from like minded traders who were as passionate about the markets as myself.

But unfortunately, CC was acquired by a Giant Vampire Squid (Goldman Sachs) in 97'. And nothing of comparison has existed since… until now.

The Macro Ops Hub

My teammates (Tyler and Anish) and I started Macro Ops (MO) with the aim of creating the site we always wanted, but which didn't exist.

We wanted to build a virtual Commodities Corp. We wanted a place where traders from all over the world could come together and share ideas, theories, trade approaches, knowledge and so on. A place where those driven by mastery and a deep respect for the game could push each other to grow and evolve — where *iron would sharpen iron*. The site would contain the highest quality trading education, research, and discussion, all of which would combine to create spontaneous developmental feedback loops leading to rapid evolution.

This is what we've done with the ***Macro Ops Hub***.

Similar to Bridgewater, the *Hub* is like an "intellectual Navy Seals" for those wanting to reach a deeper understanding of the markets and how to play them.

And the best thing about it is that we're just getting started. The *Hub* is like the Juggernaut just starting his jog.

The more quality members we accumulate, the more trade ideas and theory shared.

The more training material we put out, the more quickly the *Hub* becomes the internet's largest private database for high level trading materials.

The more you learn, the more we learn, and the better the P&L for everyone involved.

Access to the *Macro Ops Hub* includes:

- A growing and evolving set of global macro tools and resources
- Direct access to the Macro Ops team and our years of experience in the hedge fund world
- A front row seat to every trade we make in both our model portfolios
- Entrance to the *Comm Center*, an elite private forum with Operators from around the world
- A key to the trader's *Vault* which includes all our training material including our two trading courses

If you're interested in learning more about the joining the *Macro Ops Hub*, click the link below. It's time to start your journey to becoming one of trading greats…

Click Here To Learn More About The Macro Ops Hub!

Thanks for reading the ***Lessons From The Trading Greats Vol. 1***.

If you have any questions, just shoot me an email at alex@macro-ops.com

Good luck!