

INVEST? TRADE? GAMBLE?

A newcomer to the market faces three paths that lead into a forest full of treasures and dangers. The first path, for investors, goes through the sunniest areas. Most of those who take it come out alive, if not much richer. Another path, for traders, leads into the heart of the forest. Many travelers disappear, but those who come out look rich. The third is a shortcut that takes gamblers into the swamp.

How can you tell which path is which? You must choose your way carefully because if you don't, you'll end up on the gamblers' path, especially since it crosses both investors' and traders' trails. We'll return to this question in the chapters on trading psychology.

AN INTELLIGENT INVESTOR

Investors profit by recognizing new trends in the economy and buying into them before the majority wakes up to opportunities. A knowledgeable investor can earn huge percentage gains by holding his position without being terribly active.

Back in the 1970s, I bought stock in a company called KinderCare, which ran a chain of child care centers. It tried to make them as uniform and reliable as McDonalds' hamburgers. KinderCare catered to baby boomers who were having babies right, left, and center. Half of my friends were pregnant at that time. A major social shift was taking place in the United States, with women going to work in record numbers. Someone had to mind the babies of all those two-income families, and the stock of KinderCare soared on the crest of a new social trend.

AT&T used to have a monopoly on long-distance phone calls. Then in the late 1970s a tiny brash upstart called MCI won a legal dogfight,

allowing it to compete with AT&T. The age of deregulation was upon us, and the stock of MCI—the first company into the breach—sold for \$3 presenting another great opportunity to hop aboard a new trend.

A few years ago I flew into New York from the Caribbean with my friend George. He became a millionaire by buying \$30,000 worth of Dell stock before most people had heard of the company—and unloading it at the top three years later with the help of technical analysis. Sprawled in his first-class seat, George was perusing several investment advisories, trying to lock in on the next trend in Internet technology. How right he was! Within a year Internet stocks were flying, defying gravity.

That's the lure of investing. If you can buy a chunk of Dell at \$4 a share and cash out at \$80 a few years later, it is easy to fly down to a resort for a week rather than sit in front of a monitor watching every tick.

What are the disadvantages? Investing requires a great deal of patience and an immense supply of self-confidence. To buy Chrysler after it was rescued from the brink of bankruptcy or Internet search engines before anyone knew what those words meant, you had to have a huge level of confidence in your ability to read the trends in society and the economy. All of us are smart after the fact; very few are smart early in the game, and only the tiniest percentage has the emotional strength to make a large bet on their vision and hold on to it. Those who can do this consistently, like Warren Buffett or Peter Lynch, are hailed as superstars.

AN INTELLIGENT TRADER

Traders make money by betting on short-term price swings. The idea is to buy when our reading of the market tells us prices are rising and sell when the uptrend runs out of steam. Alternatively, we can bet on a decline and sell short when our analysis points to a downtrend, covering when the downtrend starts bottoming out. The concept is simple, but implementing it is difficult.

It is hard to become a good analyst, but harder to become a good trader. Beginners often assume they can make money because they're smart, computer-literate and have a record of success in business. You can get a fast computer and even buy a backtested system from a vendor, but putting money on it is like trying to sit on a three-legged stool with two legs missing. The two other factors are psychology and money management.

Balancing your mind is just as important as analyzing markets. Your personality influences your perceptions, making it a key aspect of your success or failure. Managing money in your trading account is essential

for surviving the inevitable drawdowns and prospering in the long run. Psychology, market analysis, and money management—you have to master all three to become a success.

There are two main approaches to profiting from crowd behavior. The first is momentum trading—buy when a ripple starts running through the crowd, sending the market higher, and sell when that ripple starts losing speed. It is a challenge to identify a new trend while it's still young. As the trend speeds up and the crowd becomes exuberant, amateurs fall in love with their positions. Professionals remain calm and monitor the trend's speed. As soon as they find that the crowd is returning to its normal sleepiness, they take profits without waiting for a reversal.

The other method is the countertrend strategy. It involves betting against the deviations and for a return to normalcy. Countertrend traders sell short when an upside breakout starts running out of speed and cover when a downtrend starts petering out. Beginners love to trade against trends (“let’s buy, this market can’t go any lower!”), but most get impaled on a price spike that fails to reverse. A man who likes peeing against the wind has no right to complain about his cleaning bills. Professionals can trade against trends only because they are ready to run at the first sign of trouble. Before you bet on a reversal, be sure your exit strategy and money management are fine-tuned.

Momentum traders and countertrend traders capitalize on two opposite aspects of crowd behavior. Before you put on a trade, be sure to know whether you’re investing, momentum trading, or countertrend trading. Once you’ve entered a trade, manage it as planned! Don’t change your tactics in the midst of a trade because then you’ll contribute to the winners’ welfare fund.

Amateurs keep thinking what trades to get into, while professionals spend just as much time figuring out their exits. They also focus on money management, calculating what size positions they can afford under current market conditions, whether to pyramid, when to take partial profits, and so on. They also spend a great deal of time keeping good records of their trades.

The Efficient Market Theory

A trader strains his mind, his soul, his entire being trying to take profits out of the market when an unsettling piece of news comes down the pike—the efficient market theory. Its main adherents are academics, who are fond of pointing out that prices reflect all available mar-

ket information. People buy and sell on the basis of their knowledge, and the latest price represents everything known about that market. This is a valid observation, from which the efficient market gang draws the curious conclusion that no one can beat the market. Markets know everything, they say, and trading is like playing chess against someone who knows more than you. Don't waste your time and money—simply index your portfolio and select stocks based on volatility.

What about traders who make money? The efficient market theorists say that winners are plain lucky. Most people make money at some point, before bleeding it back into the markets. What about those who keep outperforming markets year after year? Warren Buffett, one of the twentieth century's great investors, says that investing in a market in which people believe in efficiency is like playing poker against those who believe it does not pay to look at cards.

I think that the efficient market theory offers one of the truest views of the markets. I also believe it is one of the largest pieces of theoretical garbage. The theory correctly observes that markets reflect the intelligence of all crowd members; it is fatally flawed in assuming that investors and traders are rational human beings who always strive to maximize gains and minimize losses. That is a very idealized view of human nature.

Most traders can be rational on a fine weekend when the markets are closed. They calmly study their charts and decide what to buy and sell, where to take profits, and when to cut losses. When the markets open on Monday, the best laid plans of mice and men get ripped up in the sweaty palms of traders.

Trading and investing are partly rational and partly emotional. People often act on an impulse even if they harm themselves in the process of doing so. A winning gambler brags about his positions and misses sell signals. A fearful trader beaten up by the market becomes cautious beyond measure. As soon as his stock ticks down a bit, he sells, violating his own rules. When that stock rises, overshooting his original profit target, he can no longer stand the pain of missing the rally and buys way above his planned entry point. The stock stalls and slides, and he watches, first with hope and later frozen in horror, as it sinks like a rock. In the end, he can't take any more pain and sells out at a loss—right near the bottom. What's so rational about this process? The original plan to buy may have been rational, but implementing it created an emotional storm.

Emotional traders do not pursue their best long-term interests. They are too busy savoring the adrenaline rush or too twisted in fear, des-

perate to extract their fingers from a mousetrap. Prices reflect intelligent behavior of rational investors and traders, but they also reflect screaming mass hysteria. The more active the market, the more traders are emotional. Rational individuals can become a minority, surrounded by those with sweaty palms, pounding hearts, and clouded minds.

Markets are more efficient during flat trading ranges, when people are apt to use their heads. They grow less efficient during trends, when people become more emotional. It is hard to make money in flat markets because your opponents are relatively calm. Rational people make dangerous enemies. It is easier to take money from traders who are excited by a fast-moving trend because emotional behavior is more primitive and easier to predict. To be a successful trader you must keep your cool at all times and take money from aroused amateurs.

People are more likely to be rational when alone, and grow more impulsive when they join crowds. A trader's intense focus on the price of a stock, a currency, or a future pulls him into the crowd of all who trade that vehicle. As the price ticks up and down, the eyes, the heads, and the bodies of traders across the continents start moving up and down in unison. The market hypnotizes traders like a magician hypnotizes a snake, by moving his flute rhythmically up and down. The faster the price moves, the stronger the emotions. The more emotional a market, the less efficient it is, and inefficiency creates profit opportunities for calm, disciplined traders.

A rational trader can make money by remaining calm and following his rules. Around him, the crowd chases rallies, hard with greed. It sells into falling markets, squealing from pain and fear. All the while, the intelligent trader follows his rules. He may use a mechanical system or act as a discretionary trader, reading his markets and putting on trades. Either way, he follows his rules rather than his gut—that is his great advantage. A mature trader pulls money through the big hole in the efficient market theory, its presumption that investors and traders are rational human beings. Most people aren't; only winners are.

What Is Price?

Each trade represents a transaction between a buyer and a seller who meet face to face, by phone or on the Internet, with or without brokers. A buyer wants to buy as cheaply as possible. A seller wants to sell as expensively as possible. Both feel pressure from the crowd of

undecided traders that surrounds them, ready to jump in and snatch away their bargain.

A trade takes place when the greediest buyer, afraid that prices will run away from him, steps up and bids a penny more. Or the most fearful seller, afraid of getting stuck with his merchandise, agrees to accept a penny less. Sometimes a fearful seller dumps his merchandise on a calm and disciplined buyer waiting for a trade to come to him. All trades reflect the behavior of the market crowd. Each price flashing on your screen represents a momentary consensus of value among market participants.

Fundamental values of companies and commodities change slowly, but prices swing all over the lot because the consensus can change quickly. One of my clients used to say that prices are connected to values with a mile-long rubber band, allowing markets to swing between overvalued and undervalued levels.

The normal behavior of the crowd is to mill around, make noise, and go nowhere. Once in a while a crowd becomes excited and explodes in a rally or a panic, but usually it just wastes time. Bits of news and rumors send ripples through the crowd, whose shifts leave footprints on our screens. Prices and indicators reflect changes in crowd psychology.

When the market gives no clear signals to buy or sell short, many beginners start squinting at their screens, trying to recognize trading signals. A good signal jumps at you from the chart and grabs you by the face—you can't miss it! It pays to wait for such signals instead of forcing trades when the market offers you none. Amateurs look for challenges; professionals look for easy trades. Losers get high from the action; the pros look for the best odds.

Fast-moving markets give the best trading signals. When crowds are gripped by emotions, cool traders find their best opportunities to make money. When markets go flat, many successful traders withdraw, leaving the field to gamblers and brokers. Jesse Livermore, a great speculator of the twentieth century, used to say that there is time to go long, time to go short, and time to go fishing.

AN INTELLIGENT GAMBLER?

Most people gamble at some point in their lives. For most it provides entertainment, for some it becomes an addiction, while a few become pros and make a living at it. Gambling provides a living for a very small minority and entertainment for the masses, but a casual gambler

reaching for a quick buck has the same chance of success as an ice cube on a hot stove.

Some famous investors like betting on horses. They include Peter Lynch, of Magellan Fund fame, and Warren Buffett, who used to publish a newsletter on handicapping. My friend Lou, to whom my first book was dedicated, spent several years on the handicapping circuit and bet on horses for a living before buying an exchange seat and approaching financial markets like a cool handicapper. Some card games, such as baccarat, are based on chance alone, whereas others, such as blackjack, involve a degree of skill that attracts intelligent people.

Professionals treat gambling as a job. They keep calculating odds and act only when mathematics point in their favor. Losers, on the other hand, itch for the action and enter one game after another, switching between half-baked systems.

When you gamble for entertainment, follow a set of money management rules. The first rule is to limit how much you'll risk in any given session. On a rare occasion when a friend pulls me into a casino, I put what I am willing to lose that night into my right pocket, and stuff my winnings, if any, into the left one. I stop playing as soon as my right pocket is empty, without ever reaching into the left. Once in a while I find more money in the left pocket than I had in my right, but I certainly do not count on it.

A friend who is a successful businessman enjoys the glitter of Las Vegas. Several times a year he takes \$5,000 in cash and flies there for a weekend. When his bankroll runs out, he goes for a swim in the pool, enjoys a good dinner, and flies back home. He can afford to spend \$5,000 on entertainment and never blows more than his initial stake. Lounging at a pool after his cash is gone, he differs from legions of compulsive gamblers who keep charging more chips on their credit cards, waiting for their "luck" to turn. A gambler with no money management is guaranteed to bust out.

