PART ONE

Evolution of a Trader

CHAPTER 1

Trial by Fire

I was walking onto the floor of the Commodities Exchange Center (CEC), formerly within the World Trade Center in New York City. It was 1984; the gold market had just gone through its most bullish price move in history and was in the midst of its postbubble collapse. I felt the same buzz that I used to have when I played basketball in college. The trading floor reminded me of a basketball court—it had that same electric energy coursing through the air. And, I was drawn to it from a place deep within my body.

Given the events of that dreadful day in September 2001, I hesitate even to mention the Twin Towers. But it is important to understand the significance of those buildings. The World Trade Center (WTC) was a testament to the development of global trade after the gold standard was abolished and also was evidence of the burgeoning wealth just beginning to be created in the downtown canyons and exchanges.

The gleaming Twin Towers embodied the proud-to-be-an-American feeling that permeated the country in 1984. There was a groundswell of new confidence that started at the bottom, worked its way up the ladder of wealth, and emanated from the fiscal and foreign policies implemented by Ronald Reagan. President Reagan had also restored a sense of pride in the average U.S. citizen, following the disastrous confidence hit during the Carter administration. Moreover, Paul Volcker, chairman of the Federal Reserve System, had played hardball with monetary policy during the go-go-inflation period. The era was capped by the Hunt brothers' attempt to squeeze the silver market and the run in gold bullion prices to new all-time highs above $800. For gold, it had been a decade-long bull market that began when Richard Nixon removed the shackles from the U.S. dollar.

By 1984, we had already hit the second downslope in the postinflation period, as confidence was rising, prices and interest rates finally were falling, and the U.S. stock market was beginning to make some noise. While unknown at the time, the stirrings in the equity arena, flat for the better part of a decade, reflected the early phases of an evolution that would dominate the financial landscape up to the 1987 crash (and well beyond, through today).

The CEC was like a temple constructed to honor the financial gods. Huge price boards covered three of the four walls that ran more than a hundred yards on each side, with listings of dozens of commodities from potatoes to orange juice, from cotton to sugar, from platinum to heating oil and, of course, gold, silver, and copper. Under each commodity, a number of months were listed, and to the side of each month, there was a series of numbers. Those numbers represented the last trade, the first previous trade, the second previous trade, the third previous trade, the opening range, the high of the day, the low of the day, and yesterday's change.

Imagine those enormous walls covered with constantly changing numbers, flipping a thousand times faster than the train schedule at Penn Station, with people frantically jousting just to secure a space to stand. It was easily the most energetic place I had ever encountered. As I walked across the floor, I observed what can only be described as mayhem: men and women screaming at other men and women, people screaming into phones and at each other on phones, people sprinting across the floor oblivious to the bodies that went flying in nearly every direction. Arms were flailing, fists pumping, faces snarling, mouths drooling, foreheads sweating, and then there was more screaming. I did not at all understand what was happening, but I knew I had found the place I wanted to be. . . .

"Fifty bid for five" . . . "FIFTY BID FOR FIVE DAMMIT."

"Hey, am I filled or what, what are you doing in there, C'MON DAMMIT, AM I FILLED, it's trading at ten, C'MON."

"Tony, HEY Tony, TONY, HEYYYYY TOOOOONY."

"At ten, at ten, at ten, at ten, sold two, at ten, at ten, sold five, sold five, at twenty, at twenty, twenty at twenty. SOLD, twenty at twenty."

"June-Auggie, how . . . June-Auggie, how, hey Jim, where is June-Auggie . . . one bid at thirty???"

"My stop is violated, hey, did you execute my stop?" . . .

It was a free-for-all, a bunch of psychopaths screaming at one another in a foreign language that I could not understand. It was not the stodgy, stuck-up, blue-blooded, button-down white-collar environment I had imagined. In fact, wearing a suit jacket and tie made me stand out more than usual. Every nook and cranny in the place was jammed with men and women in various states of distressed-dress—open shirts, wrinkled cotton trader jackets of many colors (particularly pastels), and barely a tie to be seen. Many of the traders were sweating profusely.

Innocently enough, I was there merely to visit a friend of mine for a Manhattan-based Friday afternoon happy hour in celebration of my 24th birthday. My high school buddy Bob (Bobby-G) Gorham worked as a clerk in the gold pit. My exchange escort took me over to that area, where I stood and watched the market close. I was awestruck that such chaos could be monitored and recorded, let alone understood. That my buddy Bob knew what was going on, amid what amounted to absolute confusion, was most impressive to me. This meant that perhaps the madness made sense.

The markets closed, the screaming stopped sans the occasional trader yelling at a clerk regardless of onlookers, and Bob told me to wait while he reconciled the late-day transactions. I stood to the side trying to look inconspicuous, which since I am 6 feet 10 inches tall, is not easy to do. Sure enough, a man approached me and asked me how tall I was. I replied politely, and the soft-spoken 60 (something)-year-old gentleman, who seemed completely out of place—almost too comfortable and casual given the chaos that dominated just minutes ago—engaged me in a conversation about basketball. My new friend related his tale of collegiate hoops mastery at New York University during the 1940s when NYU was big-time city-college hoops. I shared an anecdote or two from my own big-time Division One travels with Colgate University. We spent a pleasant few minutes sharing experiences. Little did I know the impact that this seemingly casual conversation was about to have on my life.

I noticed that Bobby-G had finished his paperwork, and as he strode over to me, I introduced myself to my new friend, and excused myself at the same time. Preparing to leave for our night out, Bob turned to me and asked me what I thought. I stared him down directly in the eye, and replied that I wanted a job on the floor. When he finished laughing and saw that I was serious, he quickly spun around pointing in the direction of my new basketball buddy, Stan. Bob whispered to me that

Stan was Stanley B. Bell, Commodity Exchange (COMEX) member, CEC gold-badge holder, and owner of one of the largest brokerage firms on the exchange. In one of those life-defining, grab-the-bull-by-the-horns moments, I walked back over to Stanley B. Bell of Stanley B. Bell and Company and reintroduced myself, stating that I was looking for a job.

Stanley asked me whether I had any relevant experience. I had studied English Literature in college, and had work experience in telecommunications, but admitted that I had no market experience. I then pointed into the middle of the gold "ring" (pit) and told Stan, the ex-college Big Man on Campus, that the ring would become my next "basketball lane" and that I wanted to get in there and start throwing elbows. I told him that I sought to stake out my position and earn my living as an inside player. Stanley loved the analogy. He ate it up to the point where he immediately called out for his son to join us. I quickly learned that Stanley no longer ran the day-to-day operations, and that his son, Craig Bell, was the boss. Before I even saw Craig Bell, I knew he was approaching, just by the way the crowd parted on the trading floor. In physical stature, Craig Bell was smaller than the average man, but in pure presence, Craig Bell was a giant on the exchange floor. He stood next to me, peered straight up at me, looked over at Stanley, and exclaimed, "Who's the Jolly Green Giant?" Stanley told him that I was looking for a job. Without a moment's hesitation, Craig looked at me and told me I was hired. Then he looked back at his father and stated, "I want him right next to me in the ring." Ecstatic, I went so far as to use the phone in the booth of Stanley B. Bell and Company to call my boss at the telecom firm in New Jersey and tell him I was quitting, effectively immediately. I was to start work on the COMEX for Bell, the very next Monday. (For the record, my buddy Bobby-G and I painted the town red that Friday night in May 1984.)

When I arrived early on Monday, the premarket atmosphere on the floor was relatively serene. Clerks milled about passing paper, discussing trades, and noting the opening calls; meanwhile, traders spoke with clients on the phones, spewing out their spin per the expectations for the opening market action based on the changes in gold and silver prices during Asian and European trading.

Naturally, I was lost. But my anxiety lessened when Stanley appeared and took me under his wing, explaining the responsibilities of each member of the team. It was a well-oiled machine that operated with uncanny precision amid the chaos and confusion. The market opened, gyrated, and traded; and of course, I had no idea what was happening, or why. Stanley turned to me and suggested we go to breakfast in the members' dining room, during which time he sold me on trading as a career. I can recall the conversation as vividly today as I did later that same day. I remember Stanley Bell telling me that except for professional athletics or acting, trading was the only career that combined financial opportunities with the competitively cerebral quest to succeed.

After breakfast, we went back down to the trading floor where the activity was ongoing. Stanley turned to me and said, "You've had enough for the first day," and he sent me home.

I returned Tuesday morning, but Stanley Bell was not around (he was semiretired and by that time was only coming to the exchange floor a few hours a week). I was on my own, and no one in the company knew what to do with me until Don Tierney, a gruff and grizzled old sod who barked like a dog but had the heart of a lion, ordered me to the write-up room. This dimly lit dungeon was located one floor below the trading floor. A low ceiling covered the expanse of a luncheonette-styled room, furnished with scarred tables and broken chairs. The write-up room looked more like a bingo parlor in an outdated, antiquated New Jersey shore town on a Saturday night than like a place where fortunes were reconciled every half hour.

In fact, the write-up room was the neural network that funneled and captured all the upstairs trading floor energy. Every utterance, scream, hand signal, and nod of the head from upstairs was recreated downstairs, in sequence, to ensure that, indeed, the traders knew what they were doing. The hundreds of clerks in the write-up room provided invaluable and nonteachable skills in settling out trades and making sure that the chaos resulted in a perfect zero-sum outcome, every day. Some of the write-up room clerks were smart enough to become great traders in their own right but their innate underground skills trapped them in the write-up room. Many of them spent years trying to shed those career shackles.

I spent about an hour there copying numbers from one sheet of paper to another and handing off papers to runners while being handed new sheets of papers from other runners. Then suddenly, seemingly out of nowhere, a din arose, gradually rising until it had become a roar.

The ceiling in the write-up room literally began to shake, calling into question its ability to hold. It sounded and felt as if a stampede had been unleashed on the trading floor and was spilling down the staircase into the write-up room as runners suddenly swarmed. Above all the activity and noise, the phone rang out loud and clear. Deep down, I instantly knew what was about to happen. The clerk across the desk from me screamed, "Craig wants that tall s-o-b upstairs, *now!*"

Ordered back onto the trading floor, I made my way into the middle of the mayhem, not yet knowing that the gold market had just hit an intermediate-term bottom that would stand for several months and was in the process of reversing sharply higher. The next few hours were a blur, as I was put at the *point* spot in the silver ring. At 6 feet 10 inches tall, the mere fact that I could see over everybody—that I could see back into the Bell booth where a wall of phones was ringing off the hook—was a great advantage. I could see the clerks and signal to them where the market was and I could take their orders without them having to find a stand to climb on. Additionally, at my height, with a wingspan exceeding seven feet, I could easily reach down into the pit to hand order tickets back and forth.

As I quickly learned, the point position on the trading floor was much like the point in basketball, where a point guard handles the ball, distributes it, and runs the offense. On the floor, the point handled all the order flow into and out of the ring: on paper, verbally, and via hand signals, distributing the orders to the traders in the pit. In essence, the point handled the ball and ran the offense. And here I was, working the point with only few brief hours of experience in the industry. In short, I had no clue what I was doing.

It was truly a trial by fire.

Fortunately, pressure is a positive catalyst for me. Throw in my athletic-competitive mentality along with the allure provided by the tens of millions of dollars changing hands every minute, and I was hooked. It provided the exact atmosphere in which I thrive.

The point man is responsible for the *order book.* It is literally a book of standing orders, both above and below the market, limits and stops, that the point man holds and distributes to the pit traders as the price levels change and the orders are *touched* (the price on a standing order is reached, thus mandating that the order to buy, or sell metal, be executed).

During my first week, I let a stop order fall into the back of the order book, meaning that it was not executed when it should have been. Craig Bell had to make up the difference, making the client *whole* (pay the difference between the price at which the order was supposed to have been executed, and the price at which it eventually was executed) out of his own pocket because of my oversight. After I had realized my error and brought it to Craig's attention, he filled the order, passed the paper back to the booth, and then turned toward me while standing on the top step of the ring so that he could, almost, look at me eye-to-eye. He proceeded to rip into me, screaming right in my face. This was not overly unusual on the floor, yet it did create rubbernecking. Trading usually would come to a near halt as brokers watched in amusement while someone was ripped apart, or in extreme cases, literally beaten. Craig ripped me in front of the entire exchange, and I took it with little reaction. After all, I had screwed up and cost him almost $10,000.

I'll never forget the fallout. Taking abuse from Craig without cracking under the verbal humiliation gave me status among the other clerks, many of whom I had leapfrogged to steal the point position, even though they had much greater experience and tenure at Bell. The other Bell employees and even employees of the companies in the adjacent booths (it was a tightly knit group, working in close quarters under extreme duress) rallied around me. I had been accepted into the clerks' clique.

After the close of business, Craig Bell came over to me and calmly apologized for being so harsh. I told him I fully understood, and besides, being humiliated in front of my peers was nothing new to me, since basketball coaches, particularly my high school coach, had given me far worse dressing-downs. I told him he was a pussycat compared with them. He laughed and shook my hand, and I walked away feeling I had earned his respect. I held the point position at Bell for the next two years.

Within a week, I had arrived. The only problem was that it was still my first week and I had no clue about what was going on around me. But gradually, I realized that I could sense or feel, instinctively, when the activity in the market began to change, when dominant momentum reversed, or vice versa. I wanted a way to quantify the feeling.

At this point, I became fascinated by the point-and-figure charts (PFCs) that a couple of local traders kept by hand while trading in the pits (for a description of point-and-figure charting, see Part Four, Chapter 16).

The PFCs derive their activity from price reversals of a predetermined size. You might use one cent as a point for a PFC in silver; using a three-figure reversal would mean that the chart reflects a change for every reversal of three cents or more, including intradaily swings.

I began keeping my own point-and-figure charts for gold and silver, and later I added currencies and U.S. bonds. Tick by tick, hour by hour, day by day, week by week, for years into the future, I kept those charts. They helped me hone my natural instincts. As the charts got larger, I simply taped more paper side-to-side, and wrapped the sheets around a large piece of cardboard so that I could keep continuous charts in a microformat that was easy to update. I still have those charts, covering years of price action, in my closet.

I still had little clue *why* the markets moved, but I spent my two years on the COMEX learning exactly how order flow is handled. From micro to macro, I came to understand the business from the bottom floor, with a particular sense for the importance of momentum, as defined by the swings on my point-and-figure charts.

I came to realize the sheer power of momentum once it is unleashed and intensified by position dynamics. From a lesson that became the earliest input I had in a risk management thought process, I learned that no one is immune from the potential negative impact of momentum. It was Monday March 18, 1985. Just three weeks earlier, gold had gapped down below $300 and touched a new postbubble bear market low at $284. On Friday March 15, the market rallied and closed at the high for the week, reaching its highest level since it hit $284, and in the middle of the open downside gap from three weeks prior.

Monday morning chatter related to a potential banking crisis that involved Continental in Chicago, and word began to circulate on the floor. The market had been going straight down for months and had accelerated lower once the $335 level had given way in early December 1984. This precipitated the last leg of the bear market that culminated in the gap-down low at $284 in March 1985. In conjunction with the heavy directional move, volatility had been tanking right in line with prices, more than halving after breaking down in mid-1984, and hitting its lowest level since 1972 when gold was trading at $62.90.

Subsequent to that, and having been living large on the wild volatility, active trading, and boom times of the early 1980s, the largest pool of locals, who ran their own clearing firm, called Volume Investors, had become accustomed to a certain high-flying lifestyle. As a result, when volume began to shrink in line with the persistent bearish price action and volatility was in a virtual free fall, locals decided that selling naked call options (selling out-of-the-month calls without a "covering" purchase of the underlying commodity, leaving the option seller "open upside" risk, if the price of the commodity rose above the option's "call level") would provide a steady source of income without risk.

They were right . . . for months.

They were wrong . . . for one day. And, thanks to leverage and an explosion in volatility linked to the breaking banking crisis, when gold rallied nearly $40 that day (a single-day move of nearly 14 percent), Volume Investors was crushed, losing far more in that single day than they had made during months and months of call selling. Volume Investors went bust in one day, and some of the most powerful men on the exchange were reduced to tears. It was a memorable lesson in the sheer power of momentum, and the importance of a calculated risk assessment.

Of course, I decided that it would have been cool to have been on the other side of that trade!

For every fortune lost, a fortune is earned. That, too, is a powerful dynamic.

With my point-and-figure charts as a backbone, I immersed myself in the study of momentum. I would go to the New York City Public Library after work, and go through microfilms of the *Wall Street Journal,* writing out highs and lows on sheet after sheet of paper. Late at night, at home, I would use the calculator to apply various momentum models to the price data, creating a historical database of studies.

I was doing all this by hand, without the benefit of computers, which had yet to be introduced into the industry. Today, price quotes, charts, and customized historical studies can be accomplished with ease. I would never trade the experience for the comfort. Poring through pages and pages of data, making calculations by hand, and keeping point-and-figure charts in real time provided invaluable subconscious input that I would later harness as the "basis" for my methodology.

As my instincts became sharper, I quickly realized that the precious metals markets were losing stature as an efficient vehicle for hedging inflation risk. For one, inflation was on the decline. Second, investors had been burned by the bull market in gold and silver in the early 1980s amid exchange controls, market manipulation, a huge price rally, and subsequent collapse.

Then came the Volume Investors debacle, and many investors and local floor traders had their accounts frozen or vaporized during the firm's liquidity squeeze. Investors had become increasingly skittish about trading the metals markets. But most significantly, the introduction of new financial contracts and the increasing use of currency futures were drawing speculators away from gold and silver.

When the number of Chicago-COMEX silver arbitrage phone lines dwindled and the number of locals calling the Chicago Mercantile Exchange (CME) to place currency trades soared, the message came across to me loud and clear. I decided to transition off the trading floor into the upstairs institutional trading arena where I could expand my scope to include financial futures, particularly with the introduction of foreign fixed-income futures trading in London.