

PART I

A TRADER'S JOURNEY

The Birth of a Trader

It was 1989, and I was California dreamin'. Actually I wasn't dreaming, I was already in California, living a young single man's dream. A year or so out of college, I was residing in sunny Manhattan Beach, California, with a small apartment three blocks from the soft white sand so wonderful that they used it to help create Waikiki Beach in Hawaii. I had graduated the year before, summa cum laude, with a bachelor's degree in aerospace engineering from the University of Michigan, a top-tier engineering school. Then I had turned my back on Massachusetts Institute of Technology (MIT), California Institute of Technology (Cal Tech), Stanford University, Purdue University, and Michigan, all of whom had accepted me in their aerospace master's degree program. I turned down those great schools to live and work in sunny California, a lifelong dream.

I still remember the precise moment I made that fateful decision. On a bitterly cold winter's day in Ann Arbor, Michigan, I was walking down South University Avenue to one of my final-semester classes. The wind was blowing so hard in my face that I actually leaned into the wind to see if it would keep me up. At that point, falling face-first onto the ice-covered sidewalk would not have been much worse than feeling the stinging wind in my face. What seemed like a gale-force wind kept me upright, and then I knew—I did not want, or need, to live where it was cold in the winter when aerospace engineering graduates like me were flocking to jobs in sunny southern California. My mind was made up. Sun and sand it was.

A few weeks after graduation, I packed up my belongings, and with my sister Karen as my driving companion, drove cross-country to warm and sunny Los Angeles.

One year later, I was settled in. I had a close group of friends, most of them Midwestern transplants like me. We'd while away the weekends playing beach volleyball, usually capping the day off with a few drinks at a local pub. I loved beach living and all the entertainment it provided. Driving around the beach cities in my little red T-roof sports car, life was pretty good.

But something was missing.

I couldn't put my finger on it, but I knew this wasn't the life for me. Well, beach life certainly agreed with me, but my choice of career was the wrong one. Sure, designing future fighter airplanes and working on secret government projects was fulfilling to a degree. But I just didn't feel like it was my future. I could not see myself doing that kind of work for even 5 years, much less a career of 30 or 40 years. I needed a jolt to wake me up. That jolt came in the form of junk mail that appeared in my mailbox one day, and it changed everything.

The junk mail booklet was from Ken Roberts, a futures and commodities trader. Or at least that is how he presented himself. Looking back on it, he was definitely more of a salesman than a trader. With a nice, folksy smile and a cowboy hat, Ken laid out the riches that awaited anyone brave enough to trade futures, or commodities, as they were more commonly referred to back then.

He had a compelling story in that little booklet of his, and I'll admit I was quickly hooked. Looking at a chart of sugar, as shown in Figure 1.1, seeing all the potential profit just waiting for me, how could I not be?

At that point, words like *drawdown*, *risk of ruin*, and *emotional control* were not in my vocabulary. But *massive profits*, *easy money*, and *simple trading* suddenly were! And with a money-back guarantee, how could I go wrong? It was a risk-free entry pass into a world of unlimited profit potential—or so my naive self-thought. So I sent a check and dreamed that night about all the riches that would soon be flowing my way.

A few weeks later, I received the full trading course. It was a hefty manual, full of charts with profitable examples. Initially, I was duly impressed. But then I started to



FIGURE 1.1 Sugar Skyrocketing = Unlimited Profits?



FIGURE 1.2 Good Head and Shoulders Pattern or Just a False Signal?

look a little closer at the details. Turns out the whole course was primarily based on the 1-2-3 head and shoulders pattern. As most traders and investors know, this pattern is a classic chart pattern, as shown in Figure 1.2. It is easy to find on just about any chart you look at—you can find a profitable example or two on most any chart, any instrument, and any time frame.

The problem is that the head and shoulders pattern gives a lot of false signals and usually looks good only in hindsight. Of course, I did not know that at first. I only knew I could look at a chart, pick out the head and shoulders pattern, and see how well it worked.

I eventually found out I was missing two key pieces of the puzzle. First, when you look at a chart with a head and shoulders or any other pattern in it, it is easy to see the winning trades because you are looking at both the pattern and the outcome of that pattern. If you try hiding the outcome of a pattern, it becomes much more difficult to find the good patterns.

The second key I was missing is that the existence of a pattern, by itself, doesn't necessarily mean a trade should be taken. If you take every single head and shoulders trade you see, you will soon be broke, as shown in Figure 1.3. Of course, the naive wannabe trader in me was oblivious to this fact.

After a month of dutifully following and paper trading all the head and shoulders signals, and finding most of them to be unprofitable, I sent all my trading records, along with the manual, back for a refund. True to his word, Mr. Roberts refunded my money.

My dream of trading riches was shattered, at least temporarily. On the bright side, I now saw futures as the way to go—I just realized head and shoulders patterns were not going to be the way. Once I abandoned the get-rich-quick idea with the 1-2-3 head and shoulders patterns, I did what many scientific, numbers-oriented people do: I looked to mathematical formulas to help me in my decision making. And I started where many people do: moving averages.

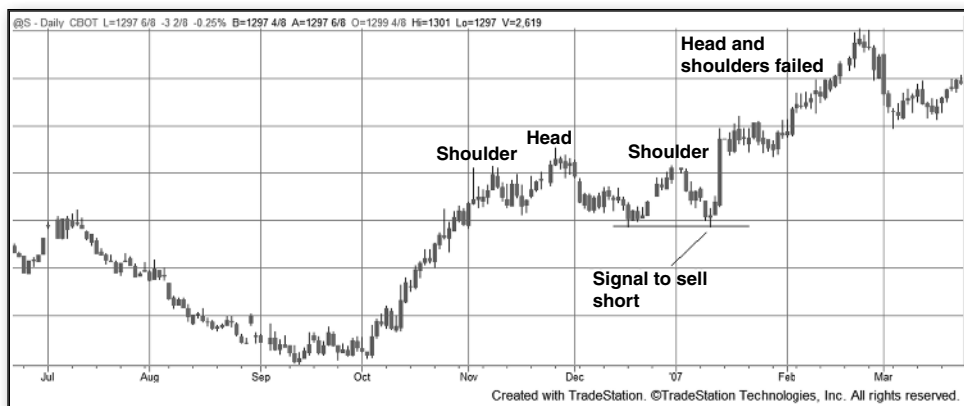


FIGURE 1.3 Many Head and Shoulders Look Good but Eventually Fail

■ My Moving Average Debacle

I'm sure every trader or investor has seen or used moving averages at some point in their trading career. Moving averages are a great way to see the general market direction, simplifying sometimes chaotic price action. But it comes at a price—lag. Moving averages will always lag whatever their calculation is based on, which can be a major problem.

There are many ways to trade with moving averages. In the simplest method, you simply buy when the price is above the moving average, and sell (or sell short) when price is below the moving average. This scheme works very well during prolonged trends, but gets absolutely hammered during trading range price action (see Figure 1.4).

Early market technician pioneers rectified this by employing two, or even three, moving averages. By using more moving averages, the idea was to filter out some of the trading range whipsaw trades, and leave the long-term, profitable trend trades.

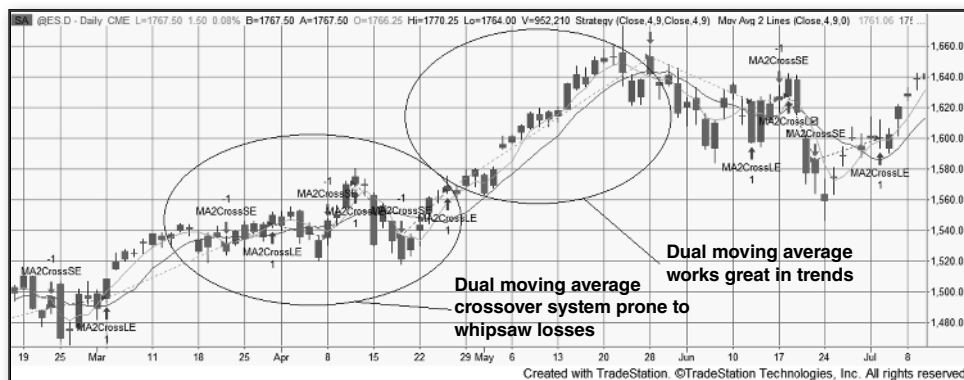


FIGURE 1.4 Great in Trends, Moving Averages Fail in Trading Ranges



FIGURE 1.5 Triple Moving Average Crossovers Can Be Deceiving

After my unsuccessful foray into futures with chart patterns, I was struck by the apparent awesomeness and simplicity of the triple moving average. Looking at a chart, it was easy to see the profitable trades, while the unprofitable whipsaw trades were much harder to detect (see Figure 1.5). During the whipsaw periods, the moving average lines were very close together, and seeing crosses of lines was exceedingly difficult. Obviously, I had learned little from my head and shoulders experience, where what I saw on the chart was deceiving me.

I quickly became a convert to the whole moving average concept, and after a few quick successful tests (I did not understand the need for testing over hundreds of trades at this point, so 10 or 20 trades, computed by hand, were good enough for me!), I decided to fund my first account. Even though I had recently purchased a condo in expensive southern California, which took most of my savings, I was able to scrape together \$5,000 to open an account. Naturally, I was nervous beyond belief. This was my nest egg, at the mercy of moving averages. In retrospect, the insanity of this is obvious, but at the time profits were all I could see.

I decided that my triple moving average system would work perfectly with live hogs, as the contract was called back then. I don't recall if this was the result of testing, where hogs looked the best, or if it was based on margin requirements, with hogs requiring relatively small margin. I suspect the latter. I liked the lower volatility of hogs, too, especially when compared to other agricultural products like soybeans and pork bellies.

With my trusty calculator, the daily newspaper, and a sheet of paper with five columns on it, every morning before work I'd record the date, closing price, and calculate the 4-, 9-, and 13-day moving averages. Then, once I got to work, I'd call my broker and place any necessary trades.

The first few days and weeks of my first trading system went fairly well. I lost more than I made, and I learned firsthand about slippage, broker's errors, and the

general inefficiency of phoning in orders. But I was surviving, which I thought was the most important thing.

Then disaster struck. I was long hogs, and one morning, I was up \$400. I was feeling great—this was my ticket to riches! At lunch, I spent a half-hour trying to convince my ultra-conservative and risk-averse engineering coworker Dave that speculating in commodities was easy for a technical-minded person. Just a few calculations, some simple math (no calculus required), and poof! Money would just add up in my account. He wasn't buying it, and I wondered why.

After lunch, I found out why. I checked hog prices right after lunch. I went from up \$400 to down \$800. A \$1,200 swing in an hour or so. Twenty-five percent of my account vaporized, just like that. I was numb. And I still had the position open since my system hadn't given me a close signal yet.

A few days later, and a few quick whipsaw losers after the big loss, I totaled the damage: \$1,500 in losses—30 percent of my account. Never in my wildest dreams had I expected that outcome. Panic set in. I stopped trading temporarily. Thank goodness I avoided the urge to double or triple my size to avenge my losses (such misguided dalliances would come later in my trading journey).

I took the weekend to regroup, and figure out my next steps. Clearly, I mistakenly thought, after a handful of trades, it was obvious that my triple moving average system was no good. If that system was terrible, my money-losing-addled mind reasoned, then the opposite system would be the answer, right? Sort of like the episode of *Seinfeld* where George Costanza flourishes when he begins to do the exact opposite of what he has always done before.

It was a *eureka* moment for me—if my first system was so bad, then the opposite system had to be just as good! Plus, I did not even need to test or evaluate this plan. All I had to do was add \$1,500 to my initial account balance, instead of subtract it (for some reason, commission and slippage losses somehow became money makers in my twisted reasoning, but that is another story). Sunday night I went to sleep, in my mind thinking I had made \$1,500 with my reverse trading system, when in actuality I had lost \$1,500 with the original system. I was excited and happy. Monday morning, I was ready to jump in with both feet.

Fast-forward a few weeks, and hogs finally hit a great trend. It was a trend that a triple moving average system picked up perfectly. If only I were trading the original method! Of course, with the “opposite” method, big trends were a killer, and that is exactly what the market provided me—a huge losing trade. After that losing trade, my account was now down \$3,000, a 60 percent account loss brought on by the triple moving average and reverse triple moving average systems. I had had enough. I raised the white flag, called it quits for a while, and decided I needed more education.