Best Process #1: Adapting to Change

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It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change.

Charles Darwin

Emil's Restaurant

Emil is a chef who purchased a restaurant in a prosperous suburb. The restaurant had not been making money for the past few years despite having a broad menu, a friendly owner, and good standing in the community. The young couples that flocked to the suburb because of its superior public education system, convenient shopping, and low crime rate wanted something other than a traditional, sit-down restaurant. They desired a bit of the city life: a lively venue for eating, drinking, meeting friends, and socializing. The old restaurant was just … too … old … and the owner could not keep pace with shifting diner tastes. So he sold the place to Emil.

Emil spoke with the new area residents to learn more about what they wanted in a restaurant. What he heard was that they wanted "fresh": fresh food, a fresh look, fresh music. He asked them to name some of their favorite urban hangouts, and then he visited the establishments. What he found was large bar areas with long tables, so that people could

mix and mingle easily and share their "small plates." Few people at those establishments sat down for large entrees and multicourse meals. Rather, it was all about grazing and drinking and mixing with people in an upbeat environment.

Emil recognized that the market had changed. What used to bring in customers no longer was attractive. A growing portion of the dining population desired a social experience, not just a quiet, well-prepared meal. They enjoyed moving around and trying different foods, not sitting and feasting on a single main dish. Creative drinks and lively contemporary sounds were an important part of the experience. The new diners wanted more than the usual background music and traditional beverage selection. They loved upbeat electronic sounds, inventive mixed drinks, craft beers, exotic soft drinks, and a broad selection of unique wines from quality vineyards.

So Emil rebuilt the business. In place of the heavy wooden dining tables and chairs, he purchased modular, colorful seating that could be quickly arranged and rearranged to create a variety of environments, from open bar to sit-down brunch. Gone were the traditional pictures on the walls, replaced by soft, streaming lights that illuminated exotic woods, stone, and glass block. Cutting-edge music videos played on large, hi-def screens, amplified by a high-quality sound system. A fresh website, Twitter feed, and Facebook page alerted diners to the day's upcoming dishes. A photoset of dishes being served was uploaded each day to Instagram and linked to other social media.

Those, however, were not Emil's most radical changes. He decided not to change the old restaurant's menu, but to do away with menus altogether. In place of the traditional fixed menu supplemented with a few "daily specials," Emil committed to making every dish fresh every day, based on ingredients he could source that morning in local markets. If Emil and staff found a superior catch of fresh fish, excellent cuts of dry-aged beef, and several local fruits and herbs, the evening's dishes featured combinations of those ingredients. Each day, he and his kitchen team created an entirely new menu. The slogan beneath the restaurant logo said it all: "A different restaurant every day."

Freed from the constraints of a menu, Emil enabled his customers to order from tablets distributed by the wait staff. Now patrons could read detailed descriptions of each dish and its ingredients, enter their orders electronically, and send orders immediately to the kitchen. The tablets were readily available throughout meals, so that diners could order fresh drinks and even share comments about what they liked best and least. Those comments helped subsequent customers make their

choices. Diners especially liked reading about suggestions for pairing dishes and beverages. As the comment base grew, the ordering system became a kind of internal social media site, where dining ideas were crowdsourced and regulars developed reputations for their food and drink reviews.

The greatest power of the ordering system was that it created a database for Emil. Over time, he learned what diners liked and didn't like. He discovered that younger males liked different drink/dish combinations than women in their mid-30s. He learned how couples ordered differently from single patrons; he found that the descriptions and pictures of dishes greatly influenced their popularity. Female customers preferred poultry and fish dishes to ones with red meat; older diners looked for quiet tables and several course meals; customers who ordered the most mixed drinks were also the ones who ordered the most specialty coffee beverages. Gradually, the database helped Emil understand which dishes to emphasize and which to eliminate. He created a different restaurant experience on weekend evenings than weekday afternoons: different food, different layout, and different music. Armed with continuous data from customers, he rapidly adapted to shifting tastes.

And the customers? They loved the up-tempo music, the clean modern lines of the décor, and the "cool" ordering app. The website gained traffic; Twitter followers and Facebook friends exploded: There was a buzz about Emil's restaurant. Were there setbacks? Of course. A customer dropped his tablet and shattered the screen. That led to new protective devices for each "menu." A few inebriated customers wrote inappropriate comments in their reviews, so Emil instituted greater monitoring of entries. Several older customers, befuddled by the newfangled electronic instrument on their table, needed to be coached on how to operate the tablet. That led to simple step-by-step instructions displayed on table tents throughout the restaurant. Each problem led to a fix, and each fix gave Emil an opportunity to show customers he cared.

Best of all, Emil was able to hire a superior kitchen and wait-staff, as people wanted to be part of this cutting-edge venture. He announced sizable bonuses for staff members who generated unique ideas implemented in the restaurant. One waiter suggested that the app could also take people's music requests, so that staff could play diners' favorite tunes during their visits. A junior chef further suggested archiving all the music choices, so that the database included the music selections for customers who completed a profile. Then, when each customer made a dining reservation, his or her favorite tunes were automatically added to the evening's playlist.

What Emil recognized is that adapting to changing markets means being willing to change who you are and what you do. The new restaurant embodied new practices (playing customers' favorite music), but also new processes (electronic ordering informed by crowdsourcing). In redefining dining's social dimensions, Emil created truly fresh experiences for customers and a distinctive "edge" in the marketplace. Thanks to a deep database tracking orders and preferences, he ensured that, in Darwin's terms, he was the "most adaptable to change."

Emil could only accomplish that, however, by embracing change. "A different restaurant every day" became both a challenge and mission. Staying fresh—never static—was the key to success. Instead of structuring the restaurant the way he wanted, Emil let the customers define the experience. His motto wasn't "If you build it, they will come." Rather, he figured out what made people come and built his restaurant around that.

The Single Greatest Barrier to Adaptation

By now you have figured out the relevance of Emil's restaurant for trading financial markets. As traders, we have ideas about how to generate returns from markets. Some of those ideas exploit macroeconomic trends or company fundamentals. Others draw their inspiration from technical patterns or carefully tested relationships among predictors and market outcomes. *Rarely, however, do market participants develop explicit processes for adapting to changing markets*. In that respect, we are like chefs who think that if we keep preparing good dishes, customers will forever line our doors. The failure to adapt to shifting markets manifests itself in sadly tone-deaf spectacles: portfolio managers chasing macroeconomic themes in markets dominated by the effects of positioning and sentiment; momentum traders playing for breakouts in low-volatility, rangebound markets; money managers adding to risk on "diversified" portfolios even as correlations and volatilities ramp higher.

In each of these cases, the result is frustration and potential emotional interference with future decision making. *The root cause of the frustration, however, is logical, not psychological*: It is the natural consequence of failing to adapt to a changing world. The restaurant owner who sold to Emil was probably frustrated with the business, but that is not why success eluded him. He was a good owner; he did what made diners happy. Unfortunately, he kept doing it long after a new kind of diner had entered the scene.

To be sure, there are traders with discipline problems and poor impulse control. There are also traders who act out unresolved emotional conflicts in markets, with predictably tragic results. But successful money managers do not suddenly morph into emotional basket cases. When we see mature professionals act out of frustration, ready—like the restaurant owner—to give up the business, there's a high likelihood that this is a failure of evolution, not merely a failure of psyche.

Key Takeaway

Emotional disruptions of trading provide information, often signaling the need to adapt to changing markets.

So why don't bright, successful professionals adapt? Why don't we, like Emil, embrace change and the stimulating challenges of renewal? Too often, the answer is ego: Once we are attached to a given reality, it becomes difficult to embrace another.

The previous restaurant owner *believed* in his menu. He was passionate about his cooking and customer service. And that passionate belief killed his business. He became so attached to—so identified with—his business model that he could not construct an alternative. He didn't *want* to become a different restaurant every day. He wanted customers to flock to the restaurant *he* believed was best.

Therein lies a considerable dilemma. Entrepreneurs need deep, enduring belief in their businesses to weather the arduous startup process. It is that belief that cements a company culture and attracts talent committed to the firm's mission. That same belief, however, can imprison us. It becomes difficult to embrace change when your very heart and soul are wedded to what you are doing. Ironically, the more committed we are to what we do, the more challenging it becomes to make the changes needed to stay ahead. Think of key innovations in the world of technology—rarely have those sprung from the industry giants. The mainframe computer makers were not those who pioneered the personal computer market; the personal computer makers were not those who popularized tablets and smart phones; social media has arisen more from startups than established software firms. Paradoxically, success can harbor the seeds of its own undoing once innovation becomes status quo.

A dramatic illustration of the difficulties of adapting to change can be found in a research study conducted in 1945 by Karl Duncker. He posed a problem to subjects in the study, showing them a corkboard wall, a box of tacks, a candle, a table, and a book of matches. The challenge was to use these resources to attach the candle to the wall in such a way that it would not drip on the table when lit. Subjects typically tried a variety of solutions, from trying to tack the candle to the wall to lighting the candle and sticking it to the wall with the drying wax. None of these solutions worked; none guaranteed that the lit candle wouldn't drip on the tabletop. The correct solution was to take the tacks out of the box, put the candle in the box, tack the box onto the wall, and then light the candle. People struggled with the problem, Duncker suggested, because of what he called functional fixedness. They were so accustomed to seeing the box as a container for tacks that they failed to envision its use as a candle holder. They were trapped, it seemed, in their mental sets.

Now here's the interesting part: Subjects facing the exact same candle problem *but initially shown the tacks outside of their box* had a much easier time solving the problem. Once the box was separated from its contents, it was not difficult for the study participants to perceive alternate uses for the box. Instead of seeing it as a container for tacks, they perceived it as an empty box. With a different perceptual frame, subjects were no longer functionally fixed and could shift their mental set and solve the seemingly unsolvable.

In our story of Emil the chef, it's clear that he succeeded, not by improving the old restaurant, but by shifting his mental set and redefining the concept of restaurant. The functionally fixed previous owner might have tried a host of menu and décor changes to no avail. As long as he stuck with the old definition of restaurant, he was bound to thwart the desires of the new generation of diners.

Emotional fixedness fuels functional fixedness. When we identify with a way of trading or a kind of analysis, we not only can't perceive alternatives: *We typically don't want to see them*. Many years ago, I spoke with an equity long/short money manager who was struggling with performance. He viewed himself as a master stock picker based on his ability to identify value that was underpriced by the market. This value orientation made him a contrarian: He liked good companies that were unloved by the Street. The problem was that unloved companies often became more unloved before the market awarded them the expected premium. The stock that was a great buy 20 percent off its highs became a burden to the portfolio once it was 35 percent below its peak. That led to

agonizing decisions about selling good companies at bargain prices versus holding losers and risking poor performance and investor redemptions.

I suggested to the manager that his dilemma might be addressed by creating a relatively straightforward money flow filter for the names in his book. I showed him how each transaction in each stock occurred either nearer to the best bid price at the time or the best offer. This execution information, summed over time, could provide a useful indication of the degree to which buyers or sellers were accumulating or distributing their shares with urgency. By waiting to size up positions in his fundamentally strong stocks until they were showing early signs of accumulation, the manager could potentially limit his drawdowns and more effectively leverage his bets.

The manager looked at me in total shock. It was as if I had suggested that he solve his domestic problems by initiating an extramarital affair. "But I'm a stock picker," he explained. "That's what I do best. If I start doing something different, I'll never succeed." For him, stocks traded on fundamentals like boxes hold tacks. He was functionally and emotionally fixed: Any analysis that did not pertain to company fundamentals was suspect. From my perspective, a money flow filter for his risk exposure could have made him a more effective fundamental stock picker, just as the social focus made Emil a better restaurateur. But our manager did not want to track money flows and refine his entry execution; he wanted to outsmart the market and find unrecognized value. In a very important sense, he was looking for self-validation, not profit maximization. And that is a powerful barrier to adaptive change.

The Power of Flexible Commitment

Antti Ilmanen's *Expected Returns* text is noteworthy for its conceptual framework. In the book, he breaks markets down into "building blocks" and explains returns in terms of the interplay of these drivers. As an active trader, I look at different building blocks than Ilmanen, but the structural approach is similar. Starting with the vast array of technical indicators in the literature, I identify a small, low-correlated set of potential market drivers and assess which are influencing price action during the most recent, stable market period. Basic to this approach is the notion of *regimes*: What drives price during one period is not what moves markets at other times. When I place a trade, I'm not simply betting that the market will rise or fall: I am also making the key assumption that

the stable (stationary) regime that has defined the most recent past will persist into the immediate future.

For example, in the regime for equity indexes that has been dominant during my writing of this chapter, sentiment and positioning have been statistically significant drivers of prospective price action. When equity put/call option ratios have been high and we've seen rises in cross-sector volatility and correlations, we've tended to see bounces in the S&P 500 Index futures. Conversely, low put/call ratios and modest volatility and correlations have led to inferior returns in the index. During other market periods, sentiment and positioning have not been so important to market returns. Factors such as momentum and market breadth have been far more valuable as market predictors. As Ilmanen notes, the drivers of price action change over time. A successful investor finds tools that capture a range of drivers and thereby harvests profits across market regimes.

There are many ways of understanding and assessing market regimes. John Ehlers, who is well known for his MESA work on market cycles, defines the time series of any asset as the result of a linear (trend) component and a cyclical (mean-reverting) component. To the extent that a market is dominated by its linear component, we want to behave as trend-followers. To the extent that a market is dominated by its cyclical component, we want to fade both strength and weakness. Success is not to be found in being either a *momentum* or a *mean-reversion* trader; perennial bulls and bears eventually meet with grief. Rather, the key to trading success lies in flexibility—the ability to adapt one's trading to shifting market environments—just as Emil adapted to the altered dining environment.

An important implication of this line of thought is that, once we define ourselves as one kind of trader, we sow the seeds of our undoing. If we identify ourselves as trend followers, we leave ourselves vulnerable to frustration in low-volatility, rangy markets. If we identify ourselves as faders of market extremes, we open ourselves to getting run over by strong momentum moves. When a market approaches the top or bottom of a range, the strategy that had made money in the cycling environment can now lead to ruin in a breakout mode.

Key Takeaway

The short life cycles of market regimes ensure that successful traders will be the fastest to adapt to changing market conditions.

This, for me as a psychologist, has been one of the greatest surprises working with professional money managers: The majority of traders fail, not because they lack needed psychological resources but because they cannot adapt to what Victor Niederhoffer refers to as "ever-changing cycles." Their frustration is a result of their rigid trading, not the primary cause. No psychological exercises, in and of themselves, will turn business around for the big-box retailer that fails to adapt to online shopping or the gaming company that ignores virtual reality. The discipline of sticking to one's knitting is destined for failure if it is not accompanied by equally rigorous processes that ensure adaptive change.

But how can we be passionately committed to what we're doing in the present and equally committed to leaving it behind as the winds of change begin to swirl?

When Chris and Gina came to my office to work on their marriage, they showed few signs of being a dysfunctional couple. They spoke in calm, even tones and did not engage in any of the bickering or defensiveness commonly seen among troubled couples. Nevertheless, they were seriously contemplating a breakup. The theme they came back to time and again was that they had grown apart. It wasn't the presence of any great conflict that led them to think about separating; rather, it was the absence of the bond they had once experienced deeply. As much as anything, they wanted to know: Where had it gone?

"Love doesn't die," the saying goes, "it has to be killed." In the case of Chris and Gina, however, it was difficult to find a murder weapon or even any murderous intent. Both were devoted to their children and household; both held jobs they liked. "We're a great team," Chris explained, "we have good times on vacations and no one could be better with the kids than Gina. But it just seems that something is missing. We don't go out like we used to, we don't do things with friends. We don't have *fun*; there's no spark. It's just not the same as it used to be."

I watched Gina closely as Chris spoke. It seemed she was uncomfortable with what he was saying, but she did not speak. Twice, she turned her head as if in deep thought and looked away from her husband. Finally, curiosity got the better of me and I asked Gina what she was thinking about. She looked a bit embarrassed and explained, "I just remembered that the kids' soccer practice was moved to the weekend." She turned to Chris, "We're going to have to get my car back from the garage.

I'll need it to take the kids tomorrow morning." Chris didn't miss a beat. He excused himself, whipped out his phone, and dialed the repair shop to make sure they didn't close early on Friday.

Like they said, they were a great team. And I had one helluva difficult counseling case.

It turns out that one of the most challenging periods for couples occurs when children first leave the home. Why is that? On the surface, the empty nest sounds appealing: ample time to socialize, pursue recreational interests, and travel! For couples who have poured themselves into family life, however, the return to couplehood can be difficult. The shared, daily focus on children is now lost. If there is nothing to replace it, suddenly there's no shared focus. Couples who thrive during such a transition are those who define and embrace new lives for themselves. They retain deep family ties, but now within a broader context of personal and joint social, recreational, and career interests. They sustain prior commitments even as they flexibly adopt new ones.

If you were to look closely, you would see that the most successful couples had already begun aspects of their new lives during their mature parenting years. As the children became older and more self-sufficient, the spouses began doing more things together and individually. They were not threatened by the developmental change in the family. Indeed, they anticipated and embraced it. The successful couples planted the seeds for their future.

The same is true of successful businesses. Firms that thrive nurture a pipeline of new products and services while they are committed to making the most of existing offerings. An automobile manufacturer readies the next generation of electric vehicles while still selling traditional gasoline-powered and hybrid units. A pharmaceutical firm knows that best-selling drugs will eventually go off-patent and conducts the research to find the next blockbusters. A baseball club scouts new talent at the same time it does all it can to maximize its current lineup.

We can only master the future if we embrace the fact that the present is temporary. To paraphrase Ayn Rand, successful people and organizations fight for the future by living in it today. For them, change poses a stimulating challenge, not an onerous ego threat. They pour themselves into their commitments even as they flexibly build fresh ones. That is because they create bridges from the old commitments to the new ones.

The parents' devotion to their children becomes a new devotion to adult children—and, eventually, to *their* families. A company's commitment to automotive excellence remains firm, even as the product line changes from gas-powered engines to hybrid and electric ones. Most people won't abandon a commitment to a cherished A in order to pursue a promising but uncertain B. Create a bridge between A and B, however, and suddenly what felt like discontinuous change is now a natural transition.

Bridges are the key to flexible commitment. Unfortunately, there were no bridges in Chris and Gina's marriage.

One of my favorite counseling exercises is to ask people to draw sine waves on a piece of paper, with about a dozen peaks and valleys. I then ask them to list their most positive life experiences at the peaks and their most difficult life experiences at the troughs. The sine waves run from childhood through early adulthood and the present. In a single view, the chart captures the peak and valley experiences of a person's life.

The reason the sine chart is so useful is that people, like markets, are patterned. No one life experience perfectly repeats another, just as no one market precisely replicates past ones. Still there are striking similarities: History, while not repeating, does indeed rhyme. Our lives, no less than any well-crafted novels or symphonies, express themes and motifs.

In the case of couples, we typically have multiple sine charts—and multiple themes. Each partner brings personal themes to a relationship, even as the relationship weaves fresh themes through the lives of the partners. A worthwhile exercise is to ask each member of the couple to fill out a sine chart for the marriage, identifying the high points and low points of the relationship. A comparison of the charts becomes quite instructive: It's possible to see, first hand, the degree to which the couple is on the same wavelength. Each fills out the chart without consulting the other ... then we compare charts.

Of course, good psychologists not only listen for what is said, but also for how it's expressed. You can learn a great deal simply by watching people and observing their postures, facial expressions, gestures, and behaviors. One of my clinical supervisors in graduate school used to ask students to watch a videotaped therapy session with the sound turned off. We then had to describe, as the tape played, what was happening in the session. I was skeptical at first—until the supervisor recounted the essence of one of my taped sessions without listening to a single word!

In the case of the sine charts, I watch to see *how* a person creates the chart. Some people immediately fill out the peaks, others start with valleys. Often, people will spend particularly long periods of time filling out particular periods in their lives—and skip over others. If someone agonizes over identifying a particular peak or valley, there's usually a reason why. An informative variation of the exercise allows each person to vary the frequency and amplitude of the sine waves. It speaks volumes when people draw huge peaks and valleys at certain life junctures, or when they draw multiple peaks or valleys in succession. My own chart drew relatively modest peaks and valleys in childhood; more pronounced ones in college and graduate school; and then a pronounced valley in the early 1980s and an equally significant peak in the mid-1980s; with a return to more moderate peaks and valleys thereafter. No Rorschach test could capture my personality as well as the charting of life-event volatility and direction. Those life-event charts, it turns out, are not so different from market charts.

Watching Gina and Chris fill out the charts told me a great deal about their relationship. Both readily identified peaks and significant valleys in their childhood years, and both identified their courtship and marriage as a significant peak, followed by the big peaks of having children. There were career and health-related ups and downs along the way, but overall their charts were not so different from mine: discrete periods of volatility caused by relationship and career uncertainty followed by the stability of meaningful commitments in both spheres. For them, as for me, crisis led to opportunity: Sometimes we don't bounce higher until we hit bottom.

That, however, was where the similarities ended. After the peaks of having children, Chris and Gina stared at their charts. And they stared. They drew small peaks corresponding to family vacations, job successes, and the accomplishments of their children and small valleys corresponding to financial and job stresses. That was it. What were supposed to be charts of the marriage were anything but. Why? Neither Gina nor Chris could identify any peaks or valleys specific to their recent married lives. They were great as a team, and they did a very efficient job of figuring out when to pick up their car in order to get their kids to the next practice—but that was it. The absence of peaks and valleys had created stability in their lives, and that stability was killing their marriage.

Over years of encouraging people to draw the sine-wave charts of their lives, one observation has stood out: peaks and valleys tend to be relatively proportional to one another. Like markets, people go through high- and low-volatility periods—and it's often the high-volatility periods that precede the greatest long-term opportunities. Consider the life histories of many of the Market Wizards interviewed by Jack Schwager: Not a few blew up early in their careers. It took huge valleys to force the self-appraisals and reorganizations that would eventually generate the significant peaks. This was a major conclusion of Thomas Kuhn when he wrote the classic, *The Structure of Scientific Revolutions*: The progress of science is typified by periods of gradual, incremental change within a paradigm, followed by accumulating anomalies (observations and questions the paradigm fails to address), and eventually followed by the upheaval of revolution and paradigm change. At those junctures incremental change yields to qualitative shifts: The science takes an entirely new direction.

A small example of paradigm shift in psychology occurred when the reigning framework of psychoanalysis gave way to more active, directive, briefer forms of intervention. Psychoanalysis was—and remains—an elegant theoretical framework with explanatory power. Freud's core idea was that present-day problems are reenactments of past, unresolved conflicts. The goal of therapy was to reenact those conflicts within the helping relationship, allowing the analyst to provide insight into the *repetition compulsion*. Once patients became aware of their repetitions, they could change those patterns within the therapeutic relationship and, from there, within their other relationships. As you might expect, analysis was a long-term affair, requiring time and effort to achieve insight, wrestle with conflicts within the therapy, and then work through those conflicts in present and past relationships. In the heyday of analysis, it was not unusual for therapy to require multiple sessions per week over a period of years.

Key Takeaway

Change occurs only once the accumulation of problems necessitates the reach for new solutions.

As it happens, people do repeat conflicts and issues throughout their lives—in their marriages and in their trading. What therapists found in

their practice, however, were Kuhnian anomalies. Some clients described vexing, long-standing problem patterns and yet managed to change them within a matter of days and weeks—not months and years. Pioneering therapists such as Alexander and French and Milton Erickson began to explore these accelerated change processes and question core tenets of psychoanalysis. What they found was powerful emotional experiences could catalyze relatively rapid change. My life turned around, not because of any grand insight accumulated over years of analysis, but from the single powerful influence of meeting the woman who would become my wife and the children who would form my new family. Anomalies had built to a crisis point in my life, and it was out of the deep emotional recognition of personal, social, and career limitations that I became ready for wholly new commitments.

Once you grasp the Kuhnian dynamic, you can appreciate why sine-wave life charts with few valleys are not necessarily good ones. Mastering the moderate challenges of childhood and adolescence is what gives us the resources to meet the challenges of life's greater valleys. University of North Carolina researcher Angela Duckworth calls this resilience "grit." It's the ability to get off the canvas after being knocked down and still have a shot at winning the fight. Learning to master the small setbacks gives us the tools and confidence to weather the much larger ones. Without experiences of grit to draw on, there is no bridge-building to the future: Change becomes a threat, not a challenge.

And the peaks? Those provide the energy and inspiration that carries us through life's valleys. Often, peaks come from fresh experience: traveling a new career path, giving birth to a child, taking a very special trip. Those new experiences help us see ourselves and our world in novel ways: They open up new possibilities and bring fresh perspectives. One of my recent peak experiences was a trip with Margie to the Alaskan wilderness. It was beautiful beyond words. More than that, however, the trip cemented our desire to see more of the world and to make that a shared experience. In a very important way, a small boat ride to the base of a glacier helped us reorder life's priorities. That is the power of peak experiences.

So what does it mean when, like Chris and Gina, there are few peaks *and* few valleys? Between the ups and downs of life, all that remains is routine. The incident in my office was a perfect example. Chris was trying to capture in words what was missing from the marriage and Gina quickly shifted the topic to a child-centered routine. At other times, it was Chris doing the shifting. On one occasion, when Gina voiced a

strong desire to keep the family together, Chris moved uncomfortably in his seat, pulled out his phone, and checked his market position. Gina stopped talking, Chris obtained his quotes, and the topic quickly changed to their mutual concern for the children. Nice, safe terrain—and more of the avoidance of change that was strangling the marriage.

The reality for Gina and Chris was that their children no longer needed to occupy dominant mindshare. Their kids were mature, growing up, and increasingly self-sufficient. Leaving home for college was soon to come. Many of the couple's routines, once glue for the relationship, no longer had a purpose. Without anything to take the place of those routines—without a bridge to the future—the couple foundered. The family had changed and they had not. They had a commitment to each other, but that wasn't enough. They needed a *flexible* commitment.

Flexibility and Trading

Ironically, no one should be able to do flexible commitment better than traders. We've all been in situations we're long and suddenly a tape bomb hits the headlines and inspires a bout of selling. What do you do? If the headline is credible and institutions are acting on the news, you very well might hedge your position, lighten it, or get out altogether. You're willing to entertain the possibility that this is a game-changer. The upward trend that you counted on is no longer a certainty. Great traders are not married to the long or the short side. They follow the market's cue—and that requires particular open-mindedness.

If we were to examine the thought process and preparation of those successful traders, we'd see that flexibility is built into their trading plans from the outset. Let's say a trader has built a model of the various fundamental drivers that impact currency prices—from trend/momentum to interest rate differentials to economic surprises—and receives a strong buy signal from his USD model. Our trader initiates long USD positions versus a basket of other currencies and knows that the Federal Reserve is scheduled to finish its meeting and make an announcement in the afternoon. Plan A for the trader is to follow the Fed announcement closely and, if monetary policy is unchanged and language is hawkish as expected, add to the positions on dips in dollar strength. Plan B, however, is to exit the positions and even reverse them should the Fed express unexpected support for monetary ease. At that point, historical odds from the model would take a backseat to the idiosyncratic risk of

the present, as a dovish tilt in monetary policy would likely bring in a fresh class of dollar sellers.

So let's say, after moving higher early in the session, the dollar sells off sharply when the Fed notes weakening economic indications and expresses renewed support for a policy of restrained rates. Quickly our trader hits bids and exits the long positions. The dollar sells off sharply and then bounces feebly as stocks stay weak and bonds rally. The intermarket action tells our trader that markets are repricing growth prospects based on the Fed statement. Quickly exiting the positions has given the trader time—and mental clarity—to look for markets slow in repricing, so that what started as a losing day can yet become a winner.

The key to our trader's morning success is not just planning the trade, but *flexibly* planning the trade. It is the active construction and rehearsal of a Plan B that enables the trader to adapt to the unexpected message from the Fed. If the trader had held an unshakable conviction that the dollar had to move higher because of momentum or interest rate movement in his macro model, such flexibility would have been impossible.

But that is flexibility in a single trade. What if we as traders lack flexibility in our basic approach to trading? What if we are like pharmaceutical firms that fail to develop pipelines of new drugs as existing ones approach the end of their patents? *What if our entire careers lack a Plan B?* Caught in trading routines, we—like Gina and Chris—can fail to create our bridges to the future. Like the chef-owner who sold to Emil, we keep cooking the meals we love, until we wake up to the fact that people are no longer coming to the table.

The key finding from the sine wave exercise with Chris and Gina was the near-absence of peak experiences in recent years. It wasn't the presence of great negatives but the absence of positives that eroded their marriage. They were so busy climbing the family ladder that they couldn't see they were leaning against the wrong building.

So how does a psychologist help a couple like Chris and Gina? The one thing that *isn't* helpful is focusing on their problems. Both husband and wife already feel as though something is wrong with their marriage. They secretly—and sometimes not so secretly—harbor concerns that something is wrong with them. They know something is broken; more talk of breakage only confirms the negative identity that they have internalized in recent years as a couple. As a rule, by the time people

come to a psychologist, they have gotten to the point of experiencing themselves as troubled. Feeling beset with problems and unable to control or change those problems, couples come to counseling in a disempowered state. Spending hour after hour with a therapist, delving into problems, subtly reinforces the notion of "troubled" and often unwittingly contributes to the initial disempowerment.

Empowering people through a focus on strengths is a cardinal tenet of the solution-focused approach to change described in *The Psychology of Trading*. When we are focused on problems and overwhelmed by them, we typically fail to appreciate the fact that there are numerous occasions in which the problems *don't* play out. These exceptions to problem patterns typically hold the kernel of solution: It's what we are doing when problems don't occur that can point the way out.

Key Takeaway

We cannot improve our functioning if we experience ourselves as dysfunctional.

Notice the subtle shift: The troubled person tells the psychologist about overwhelming problems and the psychologist responds by asking about exceptions to those problems—and then by pointing out that the kernel of solution has resided within the person all along! You see, if the solution came from the psychologist, troubled individuals would feel that they have a powerful therapist, not that they are powerful. Solution-focused work succeeds in large part because it reconnects people with their adaptive capacities: the parts of themselves that are not troubled and dysfunctional.

So the last thing we'd want to do with Chris and Gina is spend the majority of our time talking about what has been going wrong. But we don't have peak experiences on the sine-wave chart to serve as exceptions to their problem patterns. Indeed, their very problem—their deadly immersion in routine—is the absence of peak experience. How to proceed?

The answer, as I alluded earlier, is to create a bridge between present and future. What's the one thing holding the couple together? Their love for and commitment to their children. Will they work on their marriage if that would feel like taking time away from the kids? Of course not.

Without a bridge, they remain stuck in the present: They won't trade a known priority for an uncertain one. So we need a way to pursue the future while holding onto present commitments. We are most likely to change if our efforts feel evolutionary, not revolutionary.

I turned the conversation with the couple toward the absence of positives between them and how they thought that the absence affected their children. "What are you role-modeling?" I pointedly asked Gina and Chris. "If the children don't see you having fun, loving each other—being special to each other—what does that teach them about relationships? What kind of relationships would that influence them to seek out?"

I could see that the couple had never contemplated this. I wasn't telling them that they needed to have good times together to be a happy couple. Rather, I suggested that the relationship they had with each other would create a template for their children's relationship expectations. To truly be good parents for their older children, they needed to role model being a good couple. What they would do to enhance and sustain their marriage was one and the same with what they needed to do to role model the next phase of their children's development.

"Of course," I suggested gently, "if you genuinely don't feel positive things for each other, there's no sense creating a pretense for the kids. You'd probably be better off splitting up and finding good relationships that the children could come to appreciate and internalize."

Well, that was the last thing Chris and Gina wanted to hear! They could contemplate being in a marriage that wasn't working, but not working as parents? Never! The bridge was clear: The new definition of being a good parent now included being a good spouse. Their mandate was to pave the way for their children's next phase of development, not blindly repeat the parenting of the past.

So we began looking for those exception situations in which Gina and Chris were already role-modeling good things in their marriage: caring, trust, cooperation, and communication. Clearly there were a number of positives; the conversation picked up. There were no awkward interruptions. It was Gina who hit on the idea of bringing the children to see their grandparents and using the occasion to take an overnight trip as a couple. It would be family time *and* romantic time. Chris loved the idea and the two of them became animated as they planned their overnight excursion. I suggested that the energy they were displaying with each other in my office would not be lost on the children. If parents are excited and in love with each other, the home environment feels exciting and loving. What more could a parent bequeath a child?

This made huge sense for Chris and Gina.

Chris had come from a troubled, alcoholic family.

Gina had been sexually abused as a child.

They found each other and vowed that they would never hurt their children the way they were hurt. They would never take their issues out on their children.

Only when romantic love felt like part of their family commitment could they find a bridge to their future. They weren't willing to change, but they were very open to finding a better way of being who they wanted to be.

No amount of work on problems would have helped Gina and Chris. They needed to find the solution that was there all along.

So it is with many, many traders who find the future leaving them behind. They need to find the bridges that link old commitments to new, energizing directions.

The Rebuilding of Maxwell

I mentioned in the foreword that the immediate catalyst for this book was a review of ten of the top traders and portfolio managers I had worked with in the last decade. In a sense, this was my own solution-focused therapy. Performance coaches working with participants in financial markets encounter so much talk of failure, frustration, and shortcoming that it's necessary to occasionally step back and reconnect with all that is possible.

Maxwell was one of the top ten traders I had identified. For years he had been very successful trading intraday patterns in the S&P 500 e-mini (ES) futures market. His frequent refrain was that other traders were "idiots." They chased markets, put their stops at obvious levels, and otherwise replicated behaviors that provided Maxwell with a trading edge. I wouldn't describe Maxwell as particularly intellectual, but he was very intelligent—and unusually shrewd. He was an avid gambler and had an uncanny ability to figure out the other players at the poker table. He seemed to know when others were bluffing, when they were on tilt, and when they held the nuts. While he knew the probabilities attached to various hands, it was his keen perception of his opponents that enabled him to bluff, fold, or go all in.

Maxwell contended that the players in the ES futures were like rookies at the poker table. That's what made them idiots. One of Maxwell's key

trading patterns was fading "pukes." When he saw the market breaking key support and traders baling out of their positions, he knew that fear was driving the trade—and that there would soon be an opportunity to take the other side. "The market doesn't reward idiots," Maxwell once explained. By fading the fearful herd, he knew he could make a good living.

When I had the opportunity to watch Maxwell trade live, I realized how he was so consistent in his performance. He sat and sat and sat for good amounts of time, waiting for the market to "set up." During this period, he would observe the flow of volume at various price levels. Watching a depth-of-market screen, he could tell when buyers were coming in or exiting at a particular level. If buyers couldn't take out a prior high or sellers a previous low, he would quickly take the other side. To no small degree, his trading was predicated on figuring out when traders were wrong before they figured it out.

Maxwell loved busy markets: The greater the order flow, the greater the opportunity to find those occasions when bulls and bears were caught in bad positions. Most of his sitting occurred during slow market periods. "There's no one in there," he would shrug. An important part of his edge was not trading when he perceived no advantage in the marketplace.

The bull market ground on, VIX moved steadily lower, and the average daily ranges shrunk. Maxwell found himself with fewer opportunities. To make matters worse, individual traders were becoming less dominant in the market, as daytrading lost its appeal to the public in the aftermath of 2000 and proprietary trading began its descent in the wake of automated market making. With fewer idiots trading, Maxwell's profitability began a slow, steady decline. Gradually he began to wonder if he was the idiot. With larger trading firms increasingly relying on execution algorithms to get best price, prices moved differently than in the past. More than once, he lamented that the old ways of gauging buy and sell levels no longer worked.

Maxwell's risk management was good, so he wasn't losing much money. He also wasn't making much, however.

Not many peaks.

Not many valleys.

The passion ebbing.

Just like Chris and Gina—committed to what worked in the past, unable to find a bridge to the future.

You don't just wake up one morning and discover your edge is gone. Rather, as with those Kuhnian paradigms, negative evidence accumulates gradually until it is no longer possible to ignore. The restaurant owner who sold to Emil did not suddenly come to work and find no customers. The erosion occurred over time, during which he did everything possible to boost traffic: Change menu items more frequently, lower prices, run specials, and so on. All of these were changes within the same paradigm, however: They were rearrangements of deck seating on a sinking ship. Incremental changes don't work when qualitative change is necessary. For the restaurant owner, qualitative change was a bridge too far and he sold to Emil.

How many years did Gina and Chris plod forward in a marriage losing its compass before the contradictions accumulated and it was no longer possible to ignore the absence of closeness in the close home they were committed to building? An object in motion, not acted on by any outside force, remains in motion—and people are no different. We are wired to conserve energy: Constant change would be disruptive, exhausting, and inefficient.

It makes sense from a purely evolutionary perspective that what has enabled us to survive would become our default mode, our status quo. Maxwell rationalized the decline in his profitability in many ways: as the result of stress, burnout, high-speed algorithms, and just pure bad luck. Each rationalization helped sustain the status quo. "Don't fix what isn't broken" is common advice. As long as we convince ourselves that we're not broken, we don't have to seek fixes.

Key Takeaway

Routine is necessary for efficiency; breaking routine is necessary for adaptation.

There is another reason, however, why traders don't quickly embrace change in the face of changing markets and opportunities. Even when we possess a distinct and consistent edge in markets, the paths of our profitability can be highly variable. Over the long haul—100 or more trades—an edge tends to be apparent, particularly if one is not engaging in high hit rate/high blowup strategies, such as the naked selling of options. Over the course of any series of, say, 10 or 20 trades, there are random series of winning and losing bets that can play havoc with our psyches.

Last year I wrote a blog post based on the P/L Forecaster that Henry Carstens posted to his Vertical Solutions site. In researching that post, I explored three profitability curves: one with no edge whatsoever (50 percent win rate; average win size equal to average loss size); one with a negative edge (50 percent win rate; average win size 90 percent of average loss size); and one with a positive edge (50 percent win rate; average win size 110 percent of average loss size). Over the course of 100 trades, we could see the edge—or lack of edge—play out. Along the way, however, were surprising ups and downs that were purely random. By running Henry's Forecaster many times, we can see how many ways it's possible to have a constant edge and end up at a relatively constant end point, but with extremely different paths along the way.

Traders very often overinterpret these random ups and downs in the P/L curve. When they have strings of winning trades, they convince themselves that they are seeing markets well and increase their risk taking. When they encounter a series of losing trades, they become concerned about slumps and reduce their risk taking. Those adjustments ultimately cost the trader money. Imagine a baseball player who gauged his performance every 20 or so at-bats. When he gets a large number of hits, he considers himself to have a hot hand and swings even harder at pitches. When he strikes out a number of times, he talks himself into changing his swing to get out of his slump. Both adjustments take the batter out of his game. Ignoring short-term outcomes and focusing on the consistency of the swing is a far more promising approach to batting performance.

So it is for traders. Someone like Maxwell is wise to not overinterpret daily, weekly, or monthly P/L. Rather, he should assess the elements of his trading process, from his generation of trade ideas to his trade execution, and seek to make incremental improvements. When the paradigm is working, the most constructive course of action is to steadily refine the paradigm.

The problem is that, once in a while, 20 trades turn to 40 turn to 60, 80, and 100, and evidence accumulates that the trading paradigm is no longer viable. Even a small edge is apparent after enough instances: That's why it makes sense to keep betting in Vegas when the odds are with you. If you go all in on any single bet, you court risk of ruin: That randomness of the path can take you out of the game. But if you bet moderately with a constant edge, more bets allow the edge to overcome randomness. When randomness overwhelms an edge not just over a dozen or so trades, but over a great number of them, then we have

evidence that something has changed. Still, a trader like Maxwell can convince himself that this, too, shall pass.

Tracking your edge is relatively easy when you place several trades per day. What about less active investors and portfolio managers who might limit themselves to several trades per week or month? If trade frequency is low, an entire year of diminished performance could go by and represent nothing more than random bad luck in performance. Imagine, then, the trading firm that allocates more capital to the portfolio manager who has a good year and not to the one who underperforms. Those adjustments, no less than the hot hand/slump-inspired adjustments of individual traders, can drain performance over time.

It's a genuine challenge to track edge and randomness over small sample sizes of trades. If a strategy can be backtested objectively without overfitting historical data, it is possible to generate a reasonable set of performance expectations in the absence of recent, real-time trading. For a purely discretionary strategy, however, the sobering truth is that, over the course of a limited number of trades, we cannot really know whether performance is due to luck or skill. Michael Mauboussin writes convincingly about this challenge in his book, *The Success Equation* (2012), pointing out that our failure to recognize luck makes it difficult to objectively evaluate performance. An overemphasis on recent performance leads traders to place too much significance on recent runs of winning and losing trades, not recognizing the important role that luck plays in those runs. Whenever Maxwell had gotten to the point of trying to make meaningful changes in his approach to markets, he would hit a winning series of trades and convince himself that "the market is coming back." Only after hope was raised and dashed many times did he get to the point of seeking help. By that time, however, like our couple, Maxwell had gotten to the point of questioning whether he could, indeed, go forward.

Maxwell was not broken, just as Gina and Chris weren't broken. Like them, he kept doing what worked and stayed confident in his course even after it ceased to take him where he wanted to go. But also like the couple, Maxwell was doing many things well. In avoiding consensus and the herd behavior of traders, he was able to sustain a high level of intellectual and behavioral independence. His ability to detect ebbs and flows in volume helped keep him out of trades going the wrong way, even if it was now far more difficult to anticipate the market's inflection

points. In the old days, Maxwell used to be able to point to a chart level and anticipate how the market would behave once it touched that level. Those days, he realized, were long gone. There just weren't enough idiots left in the market to overreact to those chart levels!

One of my favorite solution-focused exercises in such situations is to institute a review of winning trades. Much of the role of a trading coach consists of comforting the afflicted and afflicting the comfortable. When someone is afflicted like Chris and Gina or Maxwell, some comfort in the search for exceptions to problem patterns can be empowering. When traders are in denial, doing ever more of what hasn't worked, some affliction of comfort becomes useful. A review of best trades reminds discouraged traders that they are not wholly dysfunctional. Talents, skills, and experience remain—they just need to be redeployed.

During Maxwell's trade review, we found an unusual number of winning trades held for a short time. He referred to these as *scalp trades*. "I see what's happening in the market and I jump on it," Maxwell explained. It was when he tried to identify longer-term significant price levels and hold positions for hours or days that he was no longer able to make money. From the review, Maxwell and I could clearly see he had retained his reflexes—and his capacity for quickly sizing up markets. It was his thinking about markets and not his instinctive pattern recognition that was off. In scalping mode, he was all instinct—and he made money surprisingly consistently.

Shortly after the review, Maxwell joked with me about an email he had gotten from a guru seeking to charge big bucks for sharing his wave-based trading secrets. He reminded me of my earlier blog post making fun of the "idiot wave" and shook his head at the foolishness of traders who believed such obvious sales hypes. I quickly saw my opening.

"So, Max, if you don't use wave theory, how are you going to figure out where the market will be trading at 3:00 p.m. tomorrow?"

Max laughed and joked that he already had too many crushed crystal balls and was not about to dine on more broken glass.

"But aren't you doing the same thing with your levels that the Elliott guys are doing with their waves?" I challenged. "They're predicting the future and so are you."

Maxwell looked puzzled; he wasn't sure where I was going with this. "Besides," I continued, "you don't need to predict markets to be successful. What the review of your trades told us is that you're plenty good at identifying what the market is doing at the time it's doing it.

Why predict levels for price movement when you can identify what people are doing in real time?"

You could see the wheels in Maxwell's head turn. Predicting an uncertain future was what idiots do. His job was to identify buying and selling pressure, not anticipate it.

Pattern recognition was his bridge to the future.

Kahneman, in an excellent research summary, identifies two basic modes of thinking. One is fast; the other is slow. In *Thinking, Fast and Slow* (2011), he explains that fast thinking enables us to respond to challenges in the immediate present. If a car suddenly drifts into our lane, we quickly swerve to avoid an accident. That rapid processing enables us to respond to crisis. If we had to think through every aspect of what was happening on the road, we'd hardly be able to adjust to the flow of traffic—or avoid oncoming vehicles!

The problem with fast thinking is that it is surface thinking. We perceive something, rapidly assess its relevance to us, and quickly respond. In the case of the oncoming car, that's a good thing. In the case where we see an African American man walking toward us on the sidewalk and we quickly cross the street, that same rapid processing allows bias to drive our actions. Indeed, many of the well-known cognitive biases, such as recency bias and the availability heuristic, are the result of fast processing taking control of our decisions and actions.

Slow thinking, on the other hand, is deep thinking. When we think in slow mode, we observe, catalog our observations, analyze what we've observed, and draw conclusions. Such a process is less likely to be swayed by superficial bias, but it consumes a great deal of our cognitive resources. We can drive the car and carry on a conversation while in fast mode. It's unlikely that we could solve a complex mental math problem while remaining fully attentive to road conditions. That's one reason texting and driving so often leads to disaster.

For efficiency's sake, we tend to rely on the efficient fast system except in situations that call for deep reflection. As a result, many of our decisions and actions end up reflecting first impressions, not carefully reasoned conclusions. How many times do we analyze a market, plan a trade, and then do something different in the heat of market action? The problem is not a lack of discipline per se. Rather, our fast thinking brain

has hijacked our slow, reasoning mind. Quite literally, Kahneman points out, a different part of the brain controls our fast and slow processing, sometimes taking control at the least opportune occasions.

If we think of two brains—two relatively independent information processing systems—then it isn't a far reach to identify at least two intelligences. We can be smart fast thinkers, smart deep thinkers, sometimes neither, and sometimes both. Think of very talented salespeople or highly experienced air traffic controllers. As a rule, they are not the most intellectual people—not necessarily deep thinkers—but they process information very well, very quickly, and very flexibly. The salesperson reads customers very well and subtly adjusts his or her tone of voice and message to the immediate situation. The air traffic controller doesn't think about each plane, where it's going, who operates it, and so on, but instead quickly processes the many planes coming in and out of a busy airport. This ability to quickly process rapidly changing information enables the controller to make split-second decisions that keep the system functioning efficiently and relatively accident-free.

Key Takeaway

How we think anchors how we trade.

Conversely, we've all known very bright, intellectual people who seem to lack practical sense. They can solve math problems and analyze situations, but then are clueless when it comes to reading the social cues of a dating situation. The engineer could tell you all about the construction and operation of a car engine, but it's the racecar driver who has the smarts to power the vehicle to victory at Indy.

We often refer to trading as if it's a single activity. Trading, however, is like medicine: a broad set of activities and specialties. A psychiatrist is a physician; so is a surgeon, and so is a radiologist. The skills required for each are very different. So it is in financial markets. Market making is very different from global macro portfolio management—and both are quite different from the trading of options volatility.

One of the things that make trading interesting is that it blends fast and slow thinking in myriad ways. At one extreme, we have the daytrader, who performs relatively little deep analysis, but who can excel at real-time pattern recognition. At the other extreme, we have the long-term equity investor who studies companies in depth and constructs complex

portfolios that hedge various sources of factor risk in order to profit from the price movements of strong versus weak companies. In between these two are hedge fund managers that combine the deep dives of macroeconomic analysis with the quick processing of market trends and reversals.

My experience is that successful market participants rarely excel in both slow and fast thinking, but they almost always excel in one or the other. If you look at what makes them successful, what you find is that they discover ways to engage markets that leverage either their fast processing or deep thinking skills. In a purely cognitive sense, they play to their strengths. This was certainly true of Maxwell: His scalp trades were the result of considerable fast thinking skill.

Slumps follow when traders respond to market setbacks by switching cognitive modes. The fast thinker begins to overanalyze markets and loses further touch with markets. The deep thinker becomes fearful of loss and acts on short-term price movement. Anxiety and performance pressure take traders out of their cognitive zones—and away from their strengths. So it was for Maxwell. His setbacks began in low-volatility markets that were increasingly dominated by market-making algorithms. He convinced himself that he needed to adapt to these changes by widening his holding periods and trading more strategically than tactically. Instead of following the market tick by tick and gauging order flow, he looked to longer term support and resistance levels on charts and ideas coming from earnings reports, data releases, and recent news. All of these took Maxwell out of his zone: He *was* trying to adapt to change, but doing so by becoming less of who he was at his best. Fortunately, his scalp trades kept his fast thinking skills alive—and his trading account treading water—during this wrenching period of adjustment. Over time, however, his results were becoming more average because he was increasingly relying on his relatively average deeper, analytical skills.

What turned Maxwell around psychologically, however, was that he redefined his emotional commitment to trading. Recall Chris and Gina. What was their prime motive? They wanted to be great parents and provide their children with the kind of upbringing they never had. They could not change their marriage until they reached the recognition that they couldn't be good parents to their maturing children unless they modeled a good marriage. Now their motives were aligned. They practically leaped into enhancing their marriage because they were doing it now for a good cause.

Maxwell's psychological raison d'être was that he was the smart guy who profited from the idiocy of others. Making money for him was an emotional affirmation that he was clever, unique, and distinctive.

When he stopped making money—and especially when he saw market makers profiting at his expense—he began feeling like an idiot. So what did he do? He tried to make himself into a deep thinker, someone who would be smarter than others in a different way. Ironically, he was seeking affirmation by running from his strengths.

What the solution-focused exercise demonstrated was that Maxwell was successful in a number of his trades, but that he was successful by being more tactical, not by becoming a grand strategist. As with Gina and Chris, Maxwell embraced his strengths in spades once he realized that they were the path to his emotional success. A kid from the proverbial wrong side of the tracks, Maxwell had a bit of a chip on his shoulder. He was out to prove himself to be worthy. That emotional priority wasn't going to change. We just needed to align that priority with his best trading. That became much easier when Maxwell was able to see that, in trying to predict markets, he was being one of the idiots he routinely ridiculed. He was no more willing to be an idiot than Gina and Chris were willing to be bad parents.

I won't pretend that the work with Maxwell was easy. The turnaround did not occur overnight. A great deal of work remained to distinguish why some of his tactical trading based on pattern recognition worked some of the times and not at others. It turned out that further investigations of his trading were needed. What I found in breaking down his trades was that he was losing more on the short side than the long side—and this was in markets that had been in longer-term uptrends. Subtly, Maxwell was trying to prove himself by making himself into a contrarian. When he saw that this also was acting like an idiot by swimming against the tide, he became much more open to using simple gauges to stay on the proper side of the market. For example, he defined strong, neutral, and weak markets based on early readings of how the market traded relative to its volume-weighted average price (VWAP), preventing him from fading the very strong and weak markets. By expanding the useful patterns he looked at, he was able to leverage his pattern recognition strengths.

He came to me with problems, but it was his good trading that generated the solutions. Once Maxwell found a way to bridge his fast trading skills with the emotional driver of his trading, meaningful change could occur.

That is the takeaway: *We cannot change if we fail to tap into those emotional drivers*.

The Perils of (Over)Confidence

We know how to plan for change in our trades. So why do we rarely get to Plan B in our careers? The cases of Chris and Gina and Maxwell illustrate that our core motivations and commitments can lead us to act in ways that are ultimately self-defeating. Years ago, I worked with a very successful professional who experienced considerable rejection both in childhood and later in a bad romantic relationship. She developed a commitment to self-reliance, determined that she would never be hurt and vulnerable again. As a result, she moved forward rapidly in her career—and she remained lonely, unable to sustain long-term relationships. Her commitment to independence made it difficult to sustain emotional commitments. That couldn't change until she recognized, in her own experience, that she could depend on someone she cared about and still remain independent. A turning point in her therapy occurred when she did not perform a homework exercise I had suggested. It took a while to get her to acknowledge that she was uncomfortable with the exercise and didn't want to go down that path. Instead of exploring her "resistance" to the exercise, I congratulated her on standing her ground and acting on her instincts. We then jointly crafted a different exercise.

What helped spark the change was a relationship experience. She could depend on me—*and* be independent of me. Sometimes change begins in small ways, in a single situation, a single relationship. And many times it begins in ways other than talk.

It takes a while to get to the change point, however. Those anomalies—the consequences of doing the right things and now getting the wrong results—typically have to accumulate before we contemplate doing something different. It took that young lady quite a bit of loneliness before she was willing to reach out to a counselor she could rely on. After all, when our approach to life or trading pays off in the present, we build confidence in what we're doing. That confidence can become overconfidence. We behave as if we've found a permanent life solution, as if we can continue on in our present mode and never get hurt again: never live in a troubled household, never have another losing year. Maxwell wasn't just confident about his trading during his money-making years; he was so confident that he felt no need to analyze his wins and losses or adapt to changing market conditions—until the profits stopped rolling in.

Author Robert Anton Wilson has noted the similarities between those who are totally convinced and those who are totally stupid. He also pointed out that our convictions make us convicts: We become imprisoned by our belief systems. As we saw earlier, a trader with absolute conviction in a statistical model could face quite a loss when the present idiosyncratically deviates from the past. Commitment looks like admirable discipline—until it becomes a straitjacket.

Behavioral finance research finds consistent confirmation and overconfidence biases among investors and traders. A confirmation bias occurs when we selectively process information that supports our views. Overconfidence biases lead us to overestimate the odds of an anticipated trade or market scenario working out. An interesting study of South Korean investors from Park and colleagues looked at their participation on online message boards. As you might expect, their processing of information from message boards reflected confirmation biases: Traders tended to read posts that most agreed with their views. Interestingly, those with greater confirmation bias also displayed greater overconfidence in their ideas, tended to trade more often, and tended to lose more money than did peers with lesser conviction. Scott, Stumpp, and Xu reviewed the literature in 2003 and concluded, "A considerable amount of research suggests that people are overconfident, and that investors in particular are overconfident about their abilities to predict the future" (p. 80). Moreover, they found that such overconfidence biases are present across a variety of markets and countries.

Nor is overconfidence limited to the trading world. In their book, *Decisive* (2013), the Heath brothers echo this conclusion, offering a perceptive quote from Daniel Kahneman: "A remarkable aspect of your mental life is that you are rarely stumped" (2011, p. 2). They suggest a number of strategies for overcoming overconfidence biases, including *multitracking* (entertaining multiple alternatives) and actively considering the opposite sides of our beliefs. The common element among these strategies is cognitive flexibility. Once we are not locked into particular ways of seeing problems—that is, when we are no longer functionally fixed, like the subjects in Dunker's study—we can make better life decisions. *We cannot pursue an alternative future unless we first can envision alternatives.*

It is ironic, then, that so many traders—and even trading coaches—insist that we should trade our convictions and increase risk-taking during times of high conviction. Anyone following that advice is likely to take the most risk when they are most overconfident. And all too often that's exactly what happens: Locked into large positions with über-confidence,

even flexible traders become inflexible, punctuating winning periods with outsized episodes of drawdown.

Key Takeaway

If your risk-taking mirrors your level of conviction, you will always be most vulnerable—and least able to adapt to changing markets—when you are most overconfident.

Take the case of Joe, a prop firm trader who contacted me following a prolonged period of losing performance. He had been trading stock index futures successfully for several years, but now found that his bread-and-butter trades were not profitable. Specifically, when he left relatively large, resting orders in the book, he found that these were invariably hit, with the market then trading quickly against him. "You can't win," he lamented in our initial talk. "If you don't get filled, you missed the move. If you get filled, you don't want 'em!" It felt to Joe as if someone secretly knew his positions and was pushing the market just beyond his point of tolerance. Of course, someone did know his positions: Market-making algorithms, continually monitoring and modeling the order book, could rapidly detect supply/demand imbalances and exploit them on very short time frames. A large resting order—in Joe's case many hundreds of ES contracts or more—was a sitting duck for sophisticated market makers.

A trading coach Joe had previously contacted had suggested that the problem was that Joe was not differentiating his higher conviction trades from his lower ones. If he were to clearly identify the confidence he had in a particular trade and predicate his level of risk-taking on his conviction, he would avoid lower-probability setups and maximize his performance on the higher-probability ones. It sounded good in theory, but worked poorly for two reasons. First, his increased size in his high confidence views led to even greater visibility and vulnerability in the order book. As a result, when I conducted a historical analysis, I found that his hit rate and overall profitability were lower for his identified high confidence ideas than for his more marginal trades. The second problem was that Joe was most confident when he was on a run. As a result, he would make money on one small trade, then another, then another, and then really size his positions only to have them picked off and wipe out

his prior gains. At one point, the coach urged Joe to not lose confidence in his judgment: "You have to be in it to win it!" But it was precisely when Joe was in it that he was losing it.

My analysis showed that when Joe's orders or positions reached a certain percentage of the average one-minute volume trading at that time, the odds of his trades moving against him increased dramatically. During periods of high volume and high liquidity in the book, his trades—even larger ones—were more likely to be profitable. The solution to his problem had nothing to do with conviction—or even psychology. Quite simply, Joe needed to adapt to the new market-making regime and achieve more optimal execution by distributing his orders over time with as little visibility as possible. The change that Joe needed to make was not a psychological one; like Emil, our restaurant entrepreneur, he needed to engage the marketplace in a different manner.

So why is there such an obsession with "conviction" in the trading culture? Very often, the focus on conviction keeps people from pursuing change. After all, why do anything different if you're convinced what you're doing is fine? Imagine a soldier scouting enemy terrain. The odds are good that he will not operate on the premise of conviction. He will move differently through forests and fields; he'll treat every building as a source of potential threat and will remain ever-vigilant for explosive devices. In a changing, dangerous environment, conviction gets you killed. We can only glorify confidence in trading if we cease to view markets as dangerous environments—itself quite an act of overconfidence.

In part, our focus on conviction as a success driver may simply reflect the cognitive consequences of survivorship bias. In any group of traders, the ones who lead the pack in absolute returns will almost certainly be high risk-takers. Now, of course, the cohort of worst-performing traders will also include the high risk-takers. After all, few market participants blow up their books on small bets and low conviction trades. But if we're looking for the successful market wizards, we'll usually identify those who have made the most money and, if we talk to them, we'll generally discover that they went all-in on at least some of their trades. That hindsight perspective easily leads to the assumption that a defining element of trading success is supreme confidence and risk taking.

The problem is that supreme confidence rarely permits supreme flexibility. In previous writings, I've mentioned research pertaining to positive attribution biases. We tend to attribute positive outcomes to ourselves and negative outcomes to situations. So, for example, we're likely to pat ourselves

on the back for a good market call when we make money, but complain about rigged markets when we're losing. Similarly, we tend to view ourselves in an unusually favorable light when we compare ourselves with others. A favorite exercise for a medical student class I taught asked the group to evaluate themselves relative to their peers on such adjectives as "caring" and "motivated" using a five-point scale, where 1 = much below average; 3 = average; and 5 = much above average. As you might guess, very few students rated themselves as average or below; consistently, 90 percent of the group deemed themselves to be better than average!

When I've given the exercise to groups of traders, the positive attribution bias has been every bit as clear. Most traders rate themselves as above average in ability, despite results that generally don't support such a view. When asked about the discrepancy between their self-perception and their actual trading performance, they cite their potential, their recent improvement, situational influences hampering performance, and the like. *The problem is that traders who overrate their abilities are not likely to be proactive in recognizing the need to adapt to shifting market conditions*. Joe viewed himself to be a very successful trader and attributed his recent poor performance to a "slump." That led him to seek help with his psyche, though what he needed was a way of adapting to an altered market-making environment. But the same overconfidence bias that can affect single trades can threaten trading careers. *Belief in oneself is necessary for success; flexibility in self-belief is necessary for ongoing success*.

We're now at a point where we can squarely lay out the dilemma: As traders, we operate in a domain typified by frequent, radical change: changes in trends, changes in market volatility, changes in correlations, changes in the strategies of market participants, changes in world events, changes in central bank policies, and changes in macroeconomic conditions. Consumed with the day-to-day focus on markets and need to manage risk, we rarely step back and manage change processes effectively. Like the couple stuck in their routines and restaurant owners struggling to prepare the coming day's dishes, we get by—until the rationale for those routines falls away.

Key Takeaway

Routine is necessary for efficiency; adapting our routines is necessary for effectiveness.

Tapping Core Motivations

Suppose you haven't exercised in a while. You find yourself becoming winded when you climb stairs. You don't have the same energy level, and there is a lack of flexibility to your limbs that never used to be there. You know you need to get yourself into shape. How do you begin? How do you sustain an exercise/fitness program, when you barely have enough energy to get through a busy day?

This was the situation I faced not so long ago. You would think that a psychologist who had helped many people make life changes and written numerous books and book chapters pertaining to brief approaches to change would be able to make a straightforward change of lifestyle to lose weight and get in shape. But no: One good intention and one plan after another fell by the wayside. Somehow I managed to do many things for work, markets, and family—but not for my body, *despite knowing quite well that I needed to attend to my physical needs*.

Such situations starkly illustrate that it's not a lack of knowledge or information that keeps us from making changes. All too often, we know precisely what we need to do—and we don't do it! We know we're supposed to hold the trade to our target level, but at the first wiggle against us, we're bailing out. We know we're supposed to exercise, but we stay sedentary behind our screens, drawing on ever-dwindling energy reserves.

A bit of self-disclosure: I can't recall the last time I sat through an entire television show. I attend very few parties and, when I do, I almost always leave early. Sunbathing on a beach? Puttering in the garden? Rare occurrences. Over the years, I've learned sufficient social skills to be friendly in group situations and attend to daily chores and responsibilities. But put me in a downtime situation for more than a short while and my head feels ready to explode. A physician recently asked me about my level of life stress. To her surprise, I responded that I rarely feel stressed. My one source of stress comes from feeling understimulated. If I'm not doing something meaningful, challenging, interesting, or exciting, I feel bored. Boredom feels empty. And, for me, emptiness brings its own kind of stress.

One of my poignant memories is attending a required school party during my middle school years. The students were listening to music, dancing, and talking. I sat at my desk, completely engrossed in a book I wanted to finish, William Shirer's *Rise and Fall of the Third Reich*. To the credit of the teachers, no one bothered me. I probably would have talked

with people if they had read the book. But standing around chatting and socializing and leaving the book unread? It never occurred to me.

It's not that I'm antisocial. I enjoy talking with people—indeed, it's the essence of what I do as a psychologist. Talking with people in counseling, however, is different from hanging out with neighbors at the next-door barbecue. Counseling is an instrumental activity, in which people are trying to make life changes. I enjoy those kinds of activities. What could be more exciting that being part of a person's development? Much more difficult for me are activities that seemingly have no grand design. Send me on a vacation where I can encounter a new culture and learn about history, cuisine, and ways of life and I eagerly soak it all in. Stick me on a beach with nothing but sand, sun, and surf and I'm fine for 30 minutes. Then I want to *do* something.

How is this relevant to working out and getting into shape? Intellectually, I knew that I had to attend to my physical needs. I could feel the loss of energy and saw my productivity wane as a consequence. As with Maxwell, those consequences had to accumulate before I faced the need to make changes. Running on a treadmill or doing my reps in the weight room *felt* like boring routine, however, and so I avoided them. My commitment was to productivity and meaningful challenges. Spending time jogging the streets or curling a barbell seemed contrary to that commitment. At a purely emotional level, it felt like routine, promising more boredom than fulfillment.

Now the key question: If you were my psychologist, how would you try to help me? How would you help me tap the motivation to get into shape?

The solution-focused framework that we encountered in the work with Chris and Gina and with Maxwell is particularly relevant here. When you see a problem pattern, look for exceptions to that pattern. What were my exceptions? When did I tolerate and even thrive during routine activity? When did I feel alive and stimulated when performing normal daily tasks or engaging in everyday social interaction?

Scanning the outstanding exceptions to my pattern, I identified a number of occasions in which I performed routines out of a deep sense of caring and connectedness. Every morning I wake up early and, before diving into my work, greet our four cats, pet them, and feed them breakfast. Each cat has her likes and dislikes, and each cat has her particular feeding bowl. I prepare four breakfasts and serve them one at a time to Naomi, Ginger, Mia, and Mali. *That's* a routine I love. The closeness I feel with those purring friends is the best way I can think of to start my

day. Similarly, I will spend hours searching through employment ads and reworking resumes if it will aid the job search for one of my children. When we go over resumes or practice interviews, it's not just helping them, which is important; it's also *doing something important together*. Routine doesn't feel like routine when I feel a connection, when I'm making a contribution, or when I perceive a deep purpose to the activity.

Suppose one of my children needed to perform difficult physical therapy as part of their rehabilitation from an injury. I would gladly join in the exercises and make the challenging therapy a shared effort. In such a situation, I would never avoid workouts, because of my deep commitment to my child. It's not that I would have to overcome procrastination. By tapping into a core motivation, I would encounter no emotional resistance whatsoever.

That's it: *core motivation*. It was Maxwell's core motivation to prove himself that led him to put prediction aside and maximize his scalping. It was Gina and Chris's core motivation to provide a great home for their children that sparked them to develop their marriage. *In an important sense, people never change: Instead, they find fresh ways to express the core motivations that define their life themes*. Solution-focused coaching works to the degree that it catalyzes those fresh expressions of who we already are.

Sometimes we find those fresh expressions, not through formal coaching or self-help efforts, but as the result of blind trial and error. One day I opened the door to my exercise area early in the morning, let the cats in, and used my breaks between exercises as part of my bonding time with them. I punctuated each segment of exercise with petting time with my friends. It was fun; I found myself looking forward to getting through the reps so I could have my playtime. After a few days of this, the cats became accustomed to the morning exercise routine. After eating, they now trot over to the basement door, ready for workout time. We've created a positive habit pattern—and, as it turns out, habit creation is one of the most powerful change techniques of all.

Why Discipline Doesn't Work

Once you get the idea of core motivation, you can appreciate why the usual ways we try to motivate ourselves fail. We can talk ourselves into New Year's resolutions, but if these don't tap into the core motivations that animate us, we'll inevitably leave them by the wayside. Does anyone really think that reciting affirmations, filling out journals, or any of the

usual motivational aids would have gotten me into the exercise room? Rah-rah self-talk would have fallen on deaf ears, but the cats could get me exercising. If I had to share exercise with a rehabilitating child, that would have gotten me pumped for hitting the gym every morning. It took that core motivation of tapping into a cause larger than myself to not only overcome procrastination, but eliminate it altogether.

Key Takeaway

We procrastinate when we try to push a behavior, rather than allow our core motivations to naturally pull us.

Exercise is now a routine part of my morning, in no small part because it has become a routine part of the cats' morning. I no more have to discipline myself to exercise than I have to push myself to shower in the morning or put on clean clothes. The very concept of discipline implies that we are trying to get ourselves to do something. There is a self-division: a part of us that is aligned with a "should" and a part of us that is trying to turn the "should" into a "want." We typically lose that battle, because the "shoulds" don't speak to us; they're not aligned with those core commitments that define the peaks and valleys of our lives' sine waves.

If, however, we can create habit patterns that tap those core motivations, then we swim with our emotional current. Charles Duhigg, in his book, *The Power of Habit*, captures this dynamic effectively. Citing research in cognitive neuroscience, he explains how the parts of the brain that control our habits are not those executive centers that are responsible for our reasoning and planning. Recall Kahneman's distinction between fast and slow thinking. Acting on plans versus acting on habit is the behavioral equivalent of slow and fast modes. Habits enable us to engage in relatively complex behavior while attending to new situations. If it were not for habit, for example, we could never carry on a detailed conversation while driving a car. Habit frees our minds for those slower activities that require our executive capacities: planning, reasoning, and analyzing.

Duhigg illustrates that far more of our lives are dictated by habit than we realize. This makes sense in a purely evolutionary way: The more we automate our behavior, the more we can devote limited resources to challenges at hand. The problem with our traditional efforts to "motivate" behavior is that they call on our executive brains to change our habit brains. A much more promising strategy is to change habits by

creating new ones. An alcoholic may not give up drinking buddies at the bar, but may well find a substitution and develop new buddies at A.A. A procrastination habit will not yield to reason, I found, but is easily overcome by a new habit pattern that taps our deepest commitments.

This is why much of trading psychology's emphasis on discipline is misplaced. As of my writing this, I have posted over 4000 entries to the TraderFeed blog. At a rate of one per day, that amounts to writing every single day for over ten years! But I don't write blog posts every day because I'm disciplined. I do so because I have a morning routine that taps a deep desire to meaningfully reach as many people as possible. Once you build the right habits, there is no self-division, no need for disciplining yourself to do the right things.

So how do we build the right habits? Duhigg explains that each habit pattern has a cue—something that triggers the habitual action—and a payoff. If we can find a fresh routine to link cue and payoff, a new habit pattern can be created. A good example would be the smoker who substitutes special chewing gum for cigarettes when the urge to smoke occurs. With repetition, the nicotine gum habit takes the place of the smoking habit. And that opens the door for a non-nicotine gum habit ... a vegetable munching habit ... and so on.

What makes the solution-focus effective is that it taps core life motivations as a source of new routines linking cues and payoffs. A medical student I worked with years ago was very bright and capable but struggled in school. He suffered from a social phobia and felt acutely uncomfortable in social settings. He performed well in the classroom, but froze up when going on hospital rounds with physicians and residents. Relaxation techniques and other stress management methods were to no avail. During his psychiatry rotation, a group of patients approached him about their concern for one of their peers. They were concerned that she might be lapsing into depression and could hurt herself. Most of all, they wanted to make sure the doctors did not release her prematurely. The medical student became concerned for the patient and took it on himself to seek out the resident and attending physician and initiate a case conference. His anxiety was completely gone, replaced by his caring for this vulnerable patient. Once he defined social situations as opportunities to get to know others and help them, he ceased responding with anxiety and instead felt enthusiasm. He didn't improve by battling his nervousness. Rather, he was able to engage others once he allowed a core motivation—helping others—to supplant his social fears. The implications for trading are significant: *We can only adapt to changing markets by finding fresh ways to*

express the strengths that brought us to markets in the first place. We commonly hear portfolio managers worry about "style drift." But it is precisely style that must drift if we're to adapt to markets. It is substance—the essence of our core motivations—that must remain intact.

The Purpose of Purpose

When our efforts to motivate ourselves fail to tap our core motivations, we in essence push ourselves to become someone we are not. If another person—a boss at work or a neighbor—were to push us to do something we didn't feel was right, we understandably would be resentful. We might superficially comply, but our hearts wouldn't be in it. If we perceive a deeper meaning and purpose behind acts, however, we will labor long hours and deliver superlative efforts in the service of the valuable cause. That sense of purpose has an important psychological purpose: Like a lens, it focuses our energy, allowing us to summon resources that normally remain scattered.

Adam Grant, in his eye-opening book, *Give and Take* (2013), provides compelling evidence that engaging a cause larger than oneself enhances productivity. He cites the example of a call center, where telemarketers faced frequent rejection in their efforts to raise funds. Morale was low, turnover high. One day, the call center routine was interrupted for 10 minutes to make time for a short presentation by a person who had benefited greatly from the funds raised by the calls. In the months following the presentation, measures of call center productivity skyrocketed. Fueled by a sense of inspiration and purpose, the staff looked beyond the daily routine and frequent rejection and poured itself into making more calls with greater urgency.

What is interesting in the call center is that the traditional business incentives, such as bonuses paid for superior performance, were not especially effective in motivating behavior. It was when the staff perceived a greater purpose to their work that they delivered enhanced effort.

Several years ago, I worked at a trading firm that had been very successful and then fell on leaner times. The performance problems were puzzling: Many of the traders who were there during the successful years were still there and markets had not changed so radically as to negate the performance edges of those traders. As I spoke with management, a problem became clear: The firm, run by a new CEO and staff, was now tightly controlled by a small group of people. Management meetings did not include money managers, and the outcomes of those meetings

were very rarely communicated to the risk takers. While this was done under the guise of allowing traders to focus on trading, the reality was that it alienated traders from their own organization. This showed up first in subtle ways—referring to the company as "them" rather than "us"—and then in larger ways, as company policies—including risk management rules—were violated. It was not an open revolt; the traders liked the company. It just didn't feel like *their* company. It was a company that employed them. When performance turned down and bonuses dried up, there was little residual loyalty. Several of the best traders and analysts left the firm, hollowing out the talent base. By the time the firm reached out to me, the problem was far gone. A vital, creative organization had become a dispirited one.

What Grant's work has found is that giving is surprisingly correlated with motivation and productivity. Managers who give of themselves build loyalty among employees, which then manifests itself as more positive attitudes and behaviors toward customers. Imagine how the scenario at the trading firm I described would have been different if the company had been run on the premise of servant leadership. Servant leadership is the idea that we most effectively lead others by prioritizing their needs. Think of parenting: Both authoritarian and distant parents generate resentment and rebellion among their children. When parents love, give, and care, children are most likely to want to please them and engage in the right behaviors. The servant leader listens before speaking, includes others in decision making, and takes active steps to ensure that work is satisfying for employees. Had the trading firm been run on those principles, performance challenges would have brought traders together in the service of a greater cause. The money managers would have put their heads together and generated ideas for management—and that could have led to very profitable decisions to deploy resources toward new markets and strategies. None of those things happened, however, because no one on the trading floor believed that the management suite would listen to their ideas. And they were right. Without a grander sense of purpose, the organization lost the very vitality that had built it.

One of the dramatic changes I've seen over the years is the tendency for trading at professional firms to be conducted in teams rather than on a solo basis. In the old days, managers liked to "silo" traders to ensure that they would not fall victim to groupthink and concentrate risk in overlapping positions. With the explosion of information and resources via the online medium, it simply became impractical for individuals to stay on top of everything needed by the business. Team building became

an important adaptation, allowing money managers to better conduct timely research, stay on top of fast-breaking developments, and monitor complex portfolios.

With the rise of teams, however, a new motivational dynamic entered the trading floor. The focus was not solely on markets, but also on team functioning. Team members were accountable to one another: Experienced money managers mentored the junior team members and the junior teammates took responsibility for covering areas of the market that were not the specialty of the managers. Each team member had a vested interest in the well-being and performance of the others; after all, if the team didn't make money, no one would be paid at the end of the year! Among the better teams, this created a dynamic opposite to the one I had observed at the fallen trading firm. As the business became tougher, the teams rose to the occasion, spurred by a common cause. During discouraging times, teammates lifted each other up. During periods of progress and good trading, the team celebrated as a unit. Team functioning had given a new—and in some ways larger—purpose to trading. Caring about each other became an important way of caring about the business.

Key Takeaway

What you will not do out of discipline, you will do out of inspiration.

To be sure, not everyone functions best in a team and not everyone finds their core motivations in participating in team effort. Grant's findings, however, go beyond the "give and take" of reaching out to others; they speak to the power of tapping into any purpose that is larger than oneself. One trader I worked with at a small fund is flat out one of the most creative idea generators I have ever met. Not only did he immerse himself in research daily; his research was almost always out of the box, focusing on unique aspects of markets. During one period when the traders in his shop were highly focused on events in Japan, he was immersed in options data, researching ways of utilizing skew to create asymmetric risk/reward profiles for relative value trades. He did not work in a team and interacting with others provided him with more opportunities for distraction than giving. His joy was discovery and the intellectual challenge of finding hidden edges in markets. I never knew him to suffer discipline issues in trading—not because he recited daily

affirmations or made detailed to-do lists, but because his ideas meant so much to him that he would never allow them to be compromised by ill-thought-out decisions.

At one juncture, our creative trader decided to meet with a trading coach at his firm. The coaching lasted for all of two visits. The coach proposed a standardized routine for placing and tracking trades—justified in the name of "process"—missing that the larger part of process for this trader was sustaining the creativity to find ever-new opportunity. The trader realized quickly that standardization would deplete his work environment of oxygen: He needed the freedom to innovate. As long as he was connected to a meaningful purpose, he could keep up with evolving markets. He needed innovation, not regimentation.

But—wait!—you might be thinking. If we change by reconstructing our habits, as described by Duhigg, doesn't that mean we *need* routine and standardization? How can we possibly maintain our own quality control if we don't make conscious efforts to consistently do the right things in the right ways?

For the creative trader, the answer to this seeming contradiction was that he had turned discovery into a routine: He cultivated a robust process for innovating. Think back to Emil, the restaurant owner who transformed the business. In continually polling diners, he learned their likes and dislikes and continually fed the information forward into the design of the business and the menu. This turned flexibility into a routine. Emil didn't have to motivate himself to change, because he found the adaptation process intrinsically rewarding. His sense of purpose was aroused by the opportunity to learn about his customers and better address their needs.

One of the most common questions I hear from traders is how to not become overemotional during trading, especially when losing money. Not infrequently, traders will lose money and become frustrated or anxious. Frustration leads to impulsive decision making; anxiety leads to paralysis. Both nudge the trader away from best trading practices. The underlying problem is that losses are viewed as threats. If risk management is poor, losses can be financial threats. If self-management is poor, losses can be threats to confidence and self-esteem.

Imagine a different kind of trader, however, who actively embraces losses. That trader operates under the assumption that every loss happens

for a reason. There is something to be learned from every trade outcome—good and bad. The losses can correct our views of markets or prod us to examine how we are trading those markets. Losses have a purpose; they can make us better, if only we can learn their lessons.

Now, of course, the trader who embraces losses will not like losing money, but neither will normal drawdowns pose emotional threats. No trade is a complete loss if it can be a learning experience.

Note, however, an additional benefit to the embracing of loss: It turns trade review into a habit, and that in turn makes adaptation a continuous routine. If we are always identifying what we do right during good trades and what we could improve during bad ones, we now have become process-driven in our change efforts. *Flexibility has become our routine*.

I cannot stress this enough: Over the long run, you cannot succeed as a trader or investor if you do not evolve with markets. But your evolution has to be of the kind that makes you more of who you already are. We evolve by doubling down on core motivations and signature strengths—and finding new contexts for employing what makes us distinctive. Try to change who you are and you will fight yourself all the way and then wonder, amidst the resistance, why you lack discipline. We don't need to push ourselves toward a goal when we're drawn toward our calling. That is the purpose of purpose.

Turning Adaptation into a Routine

The challenge of adapting to change occurs on all time scales for traders. Change occurs during the trading day, as volumes rise and fall and trends continue and reverse, and change occurs across entire trading careers. I recently examined what happens to the stock market when a large number of stocks register fresh five-day highs. Until 2013, there was a distinct tendency toward mean reversion: After a large proportion of S&P 500 shares closed at five-day highs, subsequent five-day returns were clearly subnormal. From 2013 forward, such five-day strength tended to bring further strength—there was evidence of momentum. As central banks continued their zero interest rate policies and money sought a home in shares, a fundamental trading pattern changed. Traders who for years had prided themselves on not chasing moves, suddenly found themselves left behind by market rallies.

A simple example of how traders fail to adapt to change can be found in their placement of stop-loss points on trades. Surprisingly often, stops

will be placed based on obvious support or resistance levels on a chart or at fixed price levels, determined by such calculations as retracement percentages of moves or Fibonacci levels. Invariably, I find, these methods for setting stops are fertile ground for trading frustration.

One reason for this is that volume changes frequently in markets, reflecting ongoing shifts in market participation. For instance, volume in SPY (the popular exchange-traded fund for the S&P 500 Index) can vary meaningfully from day to day. As of my writing this, the average daily volume in SPY for the past year is a little over 122 million shares, with a standard deviation of almost 43 million shares. Why is this variability important? It turns out that, over that year, the correlation between SPY volume and the average true range for SPY is a whopping .82. That means that over 64 percent of the variability in the day's price movement can be attributed to changes in volume.

When you think about it, that makes sense. The additional participants on higher volume days tend to be directional speculators. Their concerted action is more likely to move markets than the bid/offer participation of market makers. Low volume means that relatively few specs are in the market. As a result, the odds of a big move are reduced. Fixed methods of placing stops fail to adapt to ongoing, real-time shifts in the activity of market specs. If volume rises, the increased volatility will help ensure that stops are hit on random noise. If volume dries up, the lack of volatility will ensure that profit targets are never hit. What an adaptive trader needs is a method for calculating price targets and stop levels appropriate to evolving market conditions. Any uniform method is apt to underperform as market conditions change.

Key Takeaway

It is not enough to be consistent; you must be consistently flexible.

As I've shared on the TraderFeed blog, one way of staying adaptive is to track the most recent median market volatility and calculate the odds of hitting particular upside and downside targets should that median volatility hold for the current day. At frequent intervals during the day, adaptive traders can compare the present session's volume with the median volume *for that same time of day*. If we are busier than in the recent past, we can expect more movement and target more distant objectives.

That also suggests that stops should be wider, and we can take that into account in position sizing. Conversely, if we're trading slower than the recent past, we can be conservative in price targets and set stops accordingly. Key to this approach is a kind of Bayesian reasoning that updates estimates of volume and volatility with each fresh set of market observations. Without such a way of adapting to changing market participation, it's easy to leave profits on the table when trading picks up and fail to take profits in slower markets. That in turn can generate frustration and disrupt subsequent trading.

What is significant in the volatility-based setting of stops is a kind of process noted earlier: *turning flexibility into a routine so that change—adaptability—itself becomes a habit pattern*. This is a very important integration: The trader who adjusts targets and stops for updated estimates of market volatility is both disciplined *and* flexible. For traders, as for Emil the chef, the best processes are ones that embrace flexibility. You can be robustly process-driven *and* flexibly adaptive if you build habit patterns that enable you to identify and adapt to changing conditions.

One exercise that I've found useful for traders is having them build a flowchart of their trading process. The chart includes everything from idea generation to trade execution to position management. I don't set parameters: The charts can be as simple or as complex as needed to capture how traders make their decisions.

Two elements stand out quickly once traders complete their process flowcharts. First, some charts are relatively linear: They begin with A, move to B, proceed to C, and so forth, in a relatively straight line. Other flowcharts are filled with loops and if/then contingencies: If the market does X, then I'll do Y. If the market doesn't do X, I'll avoid Y and instead do Z. Very often, the highly branched and looped flowcharts include rules, not only for buying and selling, but for risk management. One trader I recently worked with included in his flowchart a number of branches that led to adding to positions versus taking positions down. He had created a detailed roadmap of both opportunity and risk. He had many more paths to his profitability destination than the trader with a simpler, more linear flowchart, in part because he had made position management an explicit part of his edge.

The second element that stands out in the flowcharts pertains to what lies within the loops and contingencies. For some traders, the branches

in the chart pertain to buying, selling, holding, and standing aside. For other traders, the flowchart is not so much a single chart as a set of nested charts. One branch leads to a subchart that pertains to trading longer-term trends; another branch leads to separate decision trees that capture short-term, tactical trading. It's almost as if the trader is saying, under these conditions, I'm this kind of trader; under other conditions, I'm a different trader. A trader I've known for a while has what he calls his "core strategy" for stock index trading. When conditions are not favorable for that strategy, he gauges market conditions for other opportunities in individual stocks. The flowchart that consists of multiple flowcharts potentially captures a variety of ways to win, not just a single strategy that requires the market's cooperation.

Contrast a very simple, linear flowchart of trading with a highly differentiated chart with many nodes and paths. Which chart is most likely to capture the adaptive trader?

Can traders and investors tie themselves into pretzel knots with too much complexity? Absolutely! The short-term, intuitive trader will tend to have a less differentiated flowchart than an equity long–short investor. What would distract the "scalper" from a pattern recognition edge in markets might be an essential due-diligence process for a longer-term investor. I find, however, that even successful short-term participants require a degree of differentiation—flexibility—to their processes, even if it's only to map out how to trade quiet versus busy markets or rangebound versus trending ones. One-size-fits-all would work well in perfectly static markets. When markets shift from being more correlated to less correlated; more volatile to less volatile; more directional to less so, a Procrustean approach to trading inevitably leads to suboptimal results.

Think back to Emil the restaurant innovator. His flowchart would be very detailed, describing the conditions under which he offers particular seating, particular dishes, and so on. His motto, "A Different Restaurant Every Day," neatly summarized his commitment to flexibly meeting the needs of diners. Skilled traders I have worked with have similarly been different traders in different markets. Will they express their views through currency markets or fixed income? Will they hold for a longer-term move or tactically take profits to benefit from market chop? The good traders find multiple ways to win. How different that is from the newbie whose decision making is limited to a few mechanical chart "setups"!

The degree to which a flowchart incorporates branching alternatives and different tactics and strategies reflects the trader's ability to integrate

flexible adaptability with robust, repeatable routine. *Problems occur when the market's flexibility is greater than the flexibility embedded in our processes.*

Try the flowchart exercise: Start with the ways in which you generate trade ideas and then capture the decisions you make regarding how and when you turn those ideas into trades and how you manage their risk/reward. The flowchart should capture how you prepare for the trading day and how you review your trading. Try to make the chart so detailed that a reader would be able to replicate much of how you trade.

How detailed is your flowchart? How many alternatives for making money does it capture? How well does it structure the times when you *shouldn't* be trading? How well would the process captured in the chart adapt to changes in market conditions?

If your process isn't flexible and adaptive on paper, can we really expect it to provide you with viable alternatives in the heat of battle? A good football team prepares a number of running and passing plays and flexibly draws on those to exploit the defense on the field. Our playbooks need a similar level of flexibility.

The Limits of Trader Discipline

If there is a shibboleth more common among trading coaches and traders than the value of taking risk more aggressively based on "conviction," it is the notion that trading success is a function of superior discipline. At one level, this makes sense: If a number of traders make use of a profitable methodology, it will be those that are most faithful in implementing the strategies that will achieve the most consistent returns.

Therein lies the rub, however. As a Despair.com poster wryly observes, consistency only matters if you're not a screwup. Once markets change and traders are now doing the wrong thing—as in the case of Joe—exercising greater discipline in doing the same things only locks in poor returns. Imagine a performance coach exhorting a mobile phone company to be more disciplined in its manufacturing and sales of keyboard-based smartphones just as touch screens and flexible graphical user interfaces become the consumer rage. Discipline is great for doing more of what works. *When the status quo no longer works, however, adaptability becomes the new discipline.*

Consider a different trading example. Years ago, I had found that the morning hours were my most profitable times to daytrade. A breakdown of profitability by hour of the day showed that, after a certain time, I no longer consistently made money. That analysis led me to focus my preparation and trading during my best hours and minimize my market involvement during later, slower periods. More recently, however, I found that my morning trades were not working out as well as they had previously. Despite my best efforts at consistency and discipline, the morning trades were yielding inconsistent returns. That observation—and the frustration of having what seemed to be good trades go bad—led me to carefully examine market behavior as a function of time of day. What I found was that many of the market moves I was anticipating were occurring during European and Asian trading hours, not during the standard US session. By the time I began trading in my time zone, anticipated moves had already occurred and, often, were ready for a natural retracement. Quite simply, liquidity was now distributed differently over time. I attributed this to the increasingly global nature of trade execution among "macro" traders and new intermarket relationships among international assets.

That hypothesis led me to investigate the relative dominance of macro/directional participants in global markets. After several false starts, I made progress by tracking the co-movement of asset classes (the degree to which different markets moved similarly at the same time). I was also able to gauge the directional appetite for stocks by identifying the degree to which above-average volume flows were dominantly lifting offers or hitting bids. Using a simple measure that combined money flows and asset co-movement, I could predicate my entries on how markets were moving, not just on the clock. As it happens, the morning returned as my most profitable time of day—only now the morning began at 3 a.m. EST! Anticipated market moves were occurring with the London opening, not just the New York one.

A narrow focus on discipline would have told me to look harder at my best patterns and trade those with flawless reliability. What I needed, however, was a *different kind of discipline*: one that told me to step back from what I was doing and reassess my market edge. In a very real sense, I had to embrace failure and limitation in order to sustain achievement. It was humility and open-mindedness, not any macho sense of confidence and conviction, which led to the adaptation. From that perspective, my frustration was not a problem: *It was emotional information*, telling me that I was pursuing the wrong path.

Key Takeaway

Frustration is the mother of adaptation.

Traditional trading psychology has focused on the ways in which emotions can interfere with trading. From that perspective, discipline is a way of minimizing emotions during the trading process. Experiences such as the above, however, illustrate the potential information value of disruptive emotions: *We can experience cognitive and emotional upheaval because we are no longer aligned with markets, just as emotional turmoil can nudge us out of alignment*. Not infrequently, the problem becomes a circular one: Rigid trading during changing markets leads to losses, which leads to frustration, which leads to poorer trading and even wider losses. If you are a skilled trader who has approached markets with consistency in the past and now find yourself beset with frustration, consider the possibility that your challenge is like that of the restaurant chef who sold his business to Emil: The market that made you money is now a different market. In such a case, further efforts at discipline are likely to yield marginal benefits. Discipline will help us climb the ladder of success more steadily, but in itself doesn't ensure that the ladder is propped against the right structure.

Let's get back to the insight that any market can be modeled as the sum of a trending component and one or more cyclical components. Once we detrend a market time series, it's not too difficult to identify dominant cycles during any stable lookback period. A stable (stationary) period is one that displays consistent behavior. If the period we are investigating includes wildly different market conditions—2008 and 2014 in stocks would be an example—then we are comparing apples and oranges. Before we can identify patterns or rules that the market is following, we need a stable period of analysis. Many times, traders looking for tradable systems overfit nonstationary markets, seeking universal patterns across very different markets. Within a stationary regime, we can identify how much of price action is attributable to a trend; how much can be attributed to cyclical behavior; and how much is unexplained noise.

Oren was an experienced trader who contacted me when he found himself losing money as volatility ground lower. What worried him was that he was losing in both his daytrades and his swing trades. Setups

that had worked well for him in the past now left him struggling to stay even. Wisely, he cut back his trading size and avoided doing damage to his account during his slump. Still, as weeks became months, he found himself becoming discouraged, wondering if the market would ever "come back." Each day, he planned his trades in a disciplined manner and each day he credibly followed his plans, only to chop around in his P&L.

I investigated his core market and found a distinct uptrend, accompanied by a dominant cycle of 20 to 30 trading days. The optimal trading strategy was neither one of daytrading nor swing trading. Rather, the strategy best adapted to the market conditions was a core long position, lightening up around monthly highs and adding to positions around monthly lows. Trying to time intraday moves and weekly swings simply left Oren run over by longer-term directional movement. Out of his frustration, he found himself occasionally fighting the market, telling himself, "We're due for a pullback." This left him not only out of step with the market but also fighting the trend. Oren was adaptable, but only to a point. If market moves extended beyond a swing horizon, he could not make the adjustment.

Oren did eventually adapt, but interestingly, he did so by changing markets entirely. He found several commodities markets that moved on his time frame and taught himself basic pattern recognition in those markets. Faced with a mismatch between his skills and interests and the opportunities offered by his market, he retained his core strengths and found a market more suited to his short-term decision making. He knew he couldn't change his core cognitive style, so he identified markets that rewarded his particular skill sets.

The Emotionally Intelligent Trader

In my first book, I talked about trading from the couch: reading the nuances of markets as you would read the verbal and nonverbal communications from another person. That requires a degree of emotional intelligence. An important element of emotional intelligence is the ability to put your needs and prejudices aside and remain open to the signals coming to you. In that sense, emotional intelligence *is* a kind of flexibility, the ability to adjust your thought and action to shifting streams of communication.

If you are a therapist, you cannot respond to all your clients the same way. A fragile person in mourning, an alcoholic in denial,

an executive seeking a career change—all require very different styles of communication. Parents know this well: One child may respond well to tough love; another may wilt with a single harsh look. Emotional intelligence means that you calibrate your communications to your audience if you want to make an impact. It also means that you have to listen before you speak, so that you can make the right calibration.

We've all had the experience of interacting with someone who talks at us, not with us. With such people, often you can see them formulating what they want to say before you've finished responding. Their need to talk is so strong that it interferes with communication. More attuned to their own needs than they are to you, they are singularly ineffective, whether as salespeople, parents, or romantic partners.

Traders who approach markets in a rigid way are not so different from the self-absorbed person who corners you at the office party. They impose their views on markets, not infrequently pontificating on politics, economics, chart patterns, or esoteric market theories. When markets offer their own communications—breaking out of ranges on increased institutional participation with an expansion of volatility, for example—those fixed traders are so focused on their own views that they fail to listen to the market's message. I've known traders to stay bearish through lengthy bull markets, ignoring clear signs of market strength and focusing instead on the frustrations of "manipulated markets"! Can you imagine a physician who is firmly set in his or her diagnostic preferences and ignores the presenting symptoms of patients? That physician would be open to justified charges of malpractice, as the lack of emotional intelligence would lead to unintelligent—and ultimately negligent—medical practice. Traders do not face malpractice boards; rather, they face the verdict of objective reality through their P/L. Losses are painful, but *they are there for a reason*. Very often, they can help teach us what we need to do to adapt to dynamic markets.

We commonly hear that traders should develop trading styles that fit their personalities. There is wisdom in this observation, as we shall see later in the book when we look at strengths. Indeed, one of Jack Schwager's key observations in the Market Wizards texts was that successful money managers possess different personalities, but all manage to make use of their distinctive characteristics in how they engage markets. Oren, the trader already mentioned, was a good case in point, finding markets that rewarded his information processing skills. Still, like the received wisdom about trading by conviction and the paramount importance of discipline, the notion of trading one's personality has

its limitations. As we saw with Oren, sticking to a fixed trading strategy based on the predilections of your personality can be the very embodiment of emotional unintelligence. The restaurant owner who had to sell to Emil "traded his personality": He did what he believed in. Sadly, markets are not there for our validation; they don't care about our personalities or preferences.

Key Takeaway

Just as important as trading your personality is trading the market's.

Successful traders I've known in the commodities and rates worlds have been especially good at adapting their trading to market environments. Sometimes central banks aggressively ease or tighten, creating outright directional opportunities in the fixed income instruments of particular countries. Other times, central bank officials around the world may be on hold, so that patterns of growth and weakness across different countries will end up dictating future action or inaction. At such times, "relative value" trades receiving rates in one country while paying in another can be especially effective. Similarly, going long flat price in crude oil and related commodities can be a great move in periods of Middle East conflict. Trading spreads among products to exploit seasonal and weather tendencies can make sense when distinct macroeconomic trends are not present. How the expert trader pursues opportunity in markets changes with market opportunities. It is the emotional intelligence of reading opportunity sets and sensing changing patterns in markets that enables traders to flexibly adapt their trading styles. When markets become crowded and price action becomes choppy, the style may become shorter-term and opportunistic. When positioning has cleared out and new developments are on the horizon, the trading may become longer-term and more thematic.

Emotional intelligence in a relationship means knowing when to approach and when to back off, when to speak and when to listen. If we were to investigate the daily P&L of an emotionally intelligent trader, we would find occasions of trading actively and occasions of standing back. We would see periods of high-risk taking and periods of caution. All markets are not created equal: Some bring more opportunity, some less. The self-aware trader knows when "it's my market" and goes into opportunity-seeking mode. That same trader knows when "it's not my

market" and preserves capital. One trader I worked with years ago traded very cautiously for most of the year, convinced that markets were—and would continue to be—difficult to trade. When political problems came to the European periphery, however, he drastically modified his views and aggressively traded those markets. He made his year in a few trades.

Now, to be sure, none of us is infinitely malleable. None of us can trade all markets in all ways. But neither are markets perfectly static. A worthwhile exercise you can perform is to catalog your best winning periods in the last couple of years and your greatest losing periods. If you study your markets during those times, you will most likely see differences in how those markets traded. A common pattern I've noticed among short-term traders, for instance, is that they'll tend to make money when volatility picks up and give back gains in slow, nonvolatile periods. This is because the short-term traders are often momentum traders: They need markets to follow through on moves in order to make money. An important step toward adaptation for such traders is figuring out how they could have made money during those quieter times. Perhaps they need to widen their holding periods and wait longer for anticipated moves to materialize. Perhaps they need to identify the stocks and asset classes that remain relatively volatile and limit trading to those. Or maybe they can track the relative movements of instruments and fade occasions when those get out of whack in nonvolatile environments. There are many ways to adapt; the psychological key is recognizing the need to adapt. Very often, it's the presence of those losing periods that can focus us on the need for renewal. *The emotionally intelligent trader views losses as teachers, not merely as threats*.

Jeff was unusual among traders I've known, because he made emotional intelligence his edge in markets. He developed a routine for identifying the stocks that were opening the day on unusual volume and movement. Many of these were "momo" stocks that had attracted considerable attention from the trading public. Jeff scoured Twitter, StockTwits, and popular trading sites to identify when his names had a strong and emotional public following. He only wanted to trade stocks that had broad public participation. His belief was that the trading public was prone to overreaction, creating profitable opportunities to go the other way. Thus, if traders were short a popular name, Jeff would watch for evidence of buyers coming in to meet sellers and he would quickly join

the buying. If he was right—and he often was—the short covering would make his position a winner quickly.

What was unusual about Jeff is that he traded a single strategy, but found many ways to implement it in different market conditions. He traded the long and short side, and every day he was involved with different stocks. When there was good volatility in the market or when it was earnings season, he was more active. Other days, such as slow summer trading sessions, he traded the opens and ended his days early. When his day ended, Jeff never knew what he would be trading the next day and how he'd trade it. He let the emotional trading public give him his opportunities.

Because Jeff's trading process incorporated a high degree of flexibility, he had far more staying power in the prop-trading world than most of his peers. His behavioral edge was not about to go away, as there is consistency to the behavior of herds. When herds were active, so was he; in slow times, he could stand back. Most important of all, Jeff had become a great stock picker. He could scan dozens of stocks across several trading sites and generate a list of names to trade within a relatively short time. He felt no pressure to be long or short; he had no preconceptions of the stocks he should be trading. While other traders—trend followers or breakout traders—struggled during unfriendly market periods, Jeff simply adapted his strategy to market conditions. There were always stocks showing unusual activity, so he went to where the opportunity was greatest.

Readiness for Change

So how can we make the trading changes needed to adapt to dynamic market conditions? Let's consider the broader question: How do we make *any* kind of important changes in our lives? Well-known research from James Prochaska, John Norcross, and Carlo DiClemente (1994) found that personal change does not occur all at once. There are many stages to the change process. Initially, there is little awareness of need for change, so we remain comfortable with the status quo. The researchers referred to this as a phase of *precontemplation*. Only once old ways fail us and consequences accumulate is there an active phase of *contemplation* of the need for change. During that contemplation stage, there may be many initial efforts at change and many relapses into old patterns. It is human nature to gravitate to the known and familiar. Eventually, however, consequences become so acute that the desire for change morphs into a *need* for change. That leads to a stage of *preparation*, with

initial, incremental steps toward change. Encouraged by the success of those steps, the person finally reaches the point of *action*, during which change becomes an overriding priority. Once those changes occur, the focus turns to *maintenance*: sustaining new, constructive behavior patterns and avoiding a relapse into prior, problematic ways.

If we look through the lens of this transtheoretical model, we can see that most established psychological techniques—and most coaching approaches in general—are aimed at people who are prepared to change and committed to taking action. Traditional helping methods are much less effective for those merely contemplating change. An important conclusion from the work of Prochaska et al. (1994) is that *what is effective in facilitating change for a person in an action stage of readiness is quite different from what is required to spark change for that same person in contemplation mode*. This is a principle poorly appreciated, even by seasoned mentors and coaches. It makes little sense to pursue action techniques when one is not in an action stage of readiness. Instead, if we're contemplating changes in our approaches to markets, efforts should focus on what we need to move from our current level of awareness to a point of committed action.

Key Takeaway

Many coaching and self-coaching failures result from focusing on change rather than readiness for change.

Diets are a great example of this principle: Most of us have contemplated going on a diet and many of us have started a diet—or two, or three, or more! We typically get to the point of actively contemplating change and preparing goals, but fail to sustain the leap from intention to action. Change efforts, as a result, become frustratingly circular: We take initial action, then relapse into old ways, suffer further consequences of stasis, and return to goal-setting and the desire to change. Similarly, it's not unusual for businesses to explore new directions and priorities, only to see those die on the vine as daily pressures dominate manager mindshare. Few of us consciously *choose* stasis—intellectually, we see the need for change and adaptation. As long as status quo is the default option, however, the gravitational pull of relapse becomes difficult to overcome. Focusing on action before cultivating our readiness for action keeps us orbiting the status quo.

So what stands between us and the actions we need to take to make effective changes? Typically, the missing ingredient is *urgency*. I may perceive the need to clean my house, but it is easy to put it off for another day. If I am desperate to sell my house, however, and know that someone has scheduled a second visit to make a possible purchase offer, I suddenly become quite interested in making the place look as good as possible. Spurred by the prospect of making a sale, I will experience no lack of energy for the effort. Urgency is the motive force for many successful change efforts. This is why professionals in the alcohol and drug rehabilitation field observe that people have to hit bottom before they're willing to give up their addictions. It's only when negative consequences have accumulated to the point of real pain that "want to change" turns into "need to change" and excuses lose their appeal.

A while ago, I spoke with traders in US rates markets who were scouring the job market. With global central banks anchoring short-term rates near zero, their traditional sources of market opportunity had dwindled. No longer able to make money in the usual manner by trading front ends, they foundered for a year or two before trying their hands at other markets. Now looking for positions at hedge funds, they found opportunities to be limited. The funds viewed them as beginning macro traders—not as traders with specialized fixed income expertise. Their failure to cultivate fresh sources of competitive advantage while their primary markets were still fertile left them unprepared for tectonic market shifts. By the time urgency had catapulted them to an action phase, their value in the job market had diminished significantly.

This is one of the key challenges traders face: *By the time "want to change" becomes "need to change," it is often too late—because that's after significant losses have been incurred*. Comfort—the antipode of urgency—is enemy of adaptation. After all, why fix what isn't broken? It is a rare trader who can sustain the readiness for change—move from contemplation to action—without incurring the consequences of hitting bottom. As we saw in the restaurant example, those rare traders aren't just ready for change: They love change, they embrace it. They draw immense gratification from the uncovering of new sources of competitive advantage, and so they're in a perpetual state of research and development. It's not mere passion for trading that animates the great ones; it's the passion to master markets combined with the urgency that is born of the recognition that all mastery is fleeting.

There is a great deal to be said for "fed up." When we say we're fed up, we have gotten to the point of disgust where we can no longer tolerate a situation. In my early adult years, I stayed in a suboptimal romantic relationship for far too long. I contemplated change for quite a while, and yet I did not make the step to end the situation and begin something new and promising. At one point, however, it struck me that it was precisely when I was in the company of my girlfriend that I was most lonely. It was a feeling of utter emptiness. We were scheduled to get together, but I couldn't get myself to get in the car and meet up. I lay on a porch outside one of the university buildings and stared at the sky for a very long time. From that moment, the relationship was over. I was fed up, not with the other person, but with the sense of being lonely in another person's company. Only when I hit that point of pain was I prepared to make a significant change.

Much later in life—indeed, not so long ago—my lifestyle consisted of getting up at 4 a.m. and working through the evenings on a daily basis. Weekend mornings were also set aside for work, as I kept up with markets and traders, as well as home and family responsibilities. Keeping long hours, I drank copious quantities of coffee to stay awake. I also snacked to keep myself awake, and once in a while I'd pop a couple of those analgesic tablets that consist of aspirin, acetaminophen, and caffeine. Gradually, I put on significant weight. I neglected exercise. My sleep quality deteriorated, as I woke up frequently at night. My work became less efficient, and I compensated by trying to work longer. But working longer meant more eating, more caffeine, and more fatigue through the day.

I finally got to the point where I was sleeping so poorly and was so fatigued during the day that I could not rouse myself to complete even the simplest tasks. Those willpower resources researched by Baumeister and Tierney (2011) were depleted. I simply felt like doing nothing. I was disgusted with the weight I had put on, but most of all frightened by my complete lack of initiative. I didn't feel depressed; I felt depleted—empty of reserves. It was a scary feeling. I knew in a flash that I could not sustain the status quo. I didn't want to ever feel that way again. In short, I was fed up.

That day, I withdrew entirely from caffeine and was rewarded with an epic headache for a couple of days. It didn't matter; at least I felt something! I stopped eating entirely for a day and then gradually reintroduced only the healthiest foods. Almost immediately, I lost some weight. I slept through the night. I regained energy and clarity of mind. My work became more efficient, and my nonwork time was far more

enjoyable in an energized state. I began an exercise routine of alternating weightlifting, stretching, and aerobics, which further added to the energy. Someone asked me if I would be able to sustain all those changes. I answered confidently in the affirmative. It was not that the new eating and exercising so motivated me; it was the absolute determination to not ever go back to the de-energized state in which I had found myself.

Fed up creates urgency. We often won't change what we don't like, but we *will* change what disgusts us. A big part of readiness for change consists of a deep emotional connection to consequences. Think about the successful traders interviewed by Jack Schwager in *Market Wizards* (2012). Many experienced early career blowups; they lost just about everything through poor risk management and faulty decision making. It was those traumatic losses that turned many of the traders around. They simply could not tolerate another loss like the one they had undergone. Fueled by "fed up," they moved from contemplation to active change.

So what is your level of readiness for change? How prepared would you be if tectonic shifts were to roil your markets? Let's try a short self-assessment, consisting of seven questions. *It's important that you write your responses before moving on in the book*, so please take the time to think about and sketch out your answers—after all, we're talking about your future! A few sentences for each question should be sufficient for the exercise.

Self-Assessment Exercise

- How, specifically, do you expect your market(s) to evolve over the next several years?
- Where, specifically, do you perceive the greatest areas of opportunity in your market(s) over the next several years?
- What, specifically, has been the greatest source of threat to your trading in the past year?
- How would you need to change your trading to keep pace with the shifts in markets, opportunities, and threats noted above?
- What are you doing now, *on a regular basis*, to master the learning curve needed to exploit the opportunities and avoid the threats you foresee?

- What new markets or market information are you examining in detail to help prepare you for the future?
- If you don't have clear, specific answers to the above, with whom do you need to speak and what do you need to research to gain clarity?

Please continue, but only after you've finished your responses to each question.

This was a psychological experiment. Did you continue reading without writing or after merely jotting a few cursory notes? If so, by definition you now know something important about yourself: *You are not ready for change*. You are actively contemplating change—why else would you be reading a chapter on the topic?—but your readiness does not even motivate the simple action of writing. If you felt the need for change *urgently*, you would be willing to write a dissertation if it promised a better future. Without urgency, however, the effort it takes to write is like the effort required in the gym or during a diet: easy to contemplate, difficult to sustain. That's not because we're lazy, not because we have self-defeating complexes hidden in our past, and not because we don't truly wish to improve ourselves. Quite simply, we are operating on a principle that has made sense for us evolutionarily: conservation of energy. If an animal perceives a threat, it mobilizes a flight-or-fight response. If it feels safe, it does not waste energy. Procrastination is the natural result of perceived safety; nonaction is the default mode in the animal kingdom, saving resources for those occasions when survival becomes imperative. Think of a zoo, where threats to survival are almost entirely eliminated. Even the most active and ferocious animals in the wild, placed in utter safety, spend most of their time at rest.

Key Takeaway

Comfort is the enemy of adaptation.

Psychologically, most of us live in zoos. Our basic needs provided, we face few urgent imperatives. But markets are not zoos: There is no enduring safety in ever-changing financial environments. Most traders I've seen exit the profession had contemplated change for years, but never got to the point of tearing down the bars of their psychological cages and taking definitive action.

So what does it mean if you *did* write down your responses in detail? Clearly you have thought about change and are ready to act on perceived need. In taking the action to detail your thinking about the future, you show that you are past the point of contemplation. At the very least, you are in preparation mode—and most likely, you have already undertaken initial change efforts.

The pages to come will address separately the challenges of adapting to change for those in early versus later states of readiness. If you're ready for action, we need to go beyond stoking your sense of urgency. If you're not in urgent mode, no prescriptions for action will be relevant.

So for the moment, let's set aside change and adaptation. Let's first concentrate on how to take the step from contemplation to hands-on preparation. Then, for those of you who wrote out your responses and are in your three-point stances, ready to make changes, we'll explore how to best channel your action efforts.

Tapping the Sense of Urgency

In his book, *Leading Change* (2012), John Kotter examines how organizations can make needed changes. Not surprisingly, one of his first recommended steps is "establishing a sense of urgency." After all, organizations can become as complacent and comfortable as individuals—and often for the same reasons. Change threatens the status quo; it invites uncertainty. How many people languish in suboptimal jobs and marriages simply because it's too scary to face the unknown? How many companies cling to what used to make them money long after fresh opportunities have come and gone?

Kotter outlines several strategies for catalyzing urgency within organizations, including creating crises and bombarding people with information about opportunities. In the creating crisis mode, managers go out of their way to collect information about lagging performance and keep the information in front of employees. The idea is to highlight the unpleasant negatives so that employees hit a point of concern (and fed up) that leads them to take action. Crisis turns "I should act," into "I need to act."

Bombarding members of an organization with opportunity-related communications is, in some ways, the opposite strategy. By placing outrageous goals in front of people and showing them what is possible, inspiration can spark steps toward action. We can call the first strategy the fear approach: Nudge people into action by impressing them with

the consequences of inaction. A physician who tells a patient what could happen to his heart if he continues to eat in unhealthy ways is using the fear motivator. Conversely, a physician might try to convince the patient that he will have so much more energy and will look so much better if he loses weight. This inspiration strategy relies on capturing the person's imagination and exciting them about the benefits of change.

There is an important respect, however, in which fear and inspiration are not opposite strategies. *Both nudge people out of their comfort zone by changing their emotional states*. The shift from contemplation to preparation and action cannot occur in a status quo mindset. It is necessary to shift the heart in order to shift mind and behavior.

Kotter mentions one effective approach: setting performance targets so high that they cannot be reached through business as usual. If those targets become mandates, they shake people up. Now the greatest risk is not change, but failing to change. If failure is not an option, teams will go to extremes to meet their stretch targets, finding creative alternatives that never could have emerged from status quo thinking and planning. You've probably seen the television show *The Biggest Loser* in which morbidly obese contestants publicly compete to lose the most weight. For years, each of these contestants was unable to lose weight on their own. Now, with coaching, the motivation of competition, and the pressure of public scrutiny, they make Herculean efforts to lose phenomenal amounts of weight. What changed? A fresh set of motivations engaged contestants emotionally and propelled them out of contemplation and into preparation and eventual action.

Think about the extreme training challenges that soldiers endure in order to become part of Special Forces teams. Few people on their own would sustain a regimen of sleeplessness, constant exercise, and harassment from overseers. But once in the program, bonded to peers and inspired to wear the insignia of achievement, the soldiers dig deep and find resources they never knew they had. How can it be that we can be so wedded to inertia and, at the same time, so capable of revolutionary achievements? Without emotional engagement, change simply becomes an object of intellectual contemplation. It is only when we feel the need and desire for change that we become committed—and then anything short of action becomes unacceptable. *Emotional change precedes behavioral change—always*.

Parents are very familiar with the challenges of bridging contemplation and action. Children often know what they should do, but other priorities get in the way. When our two youngest children were growing up, it wasn't easy to get them to straighten their rooms, do their schoolwork, and so on. Finally, we hit on the idea of creating "sticker charts." Each time the kids completed their chores for the day, they got a sticker. If they received stickers every single day of the week, they could redeem their filled chart for a "weekend toy."

Now, as it turns out, "weekend toy" was a big deal. It meant that I took Devon and Macrae to a mall and usually out to eat. We would wander the aisles together and they would get to pick out their favorite toy or game. The toy was only part of what made the outing special; it was also quality time for family, where kids were the total focus.

The sticker charts changed the equation for getting chores done. Failure to keep up with responsibilities led to an alert: no sticker, no weekend toy outing. The alert, however, was delivered in a positive way: "I really would like to go out with you this weekend. C'mon, let's make up your bed!" Suddenly an onerous and boring chore turned into an interpersonal bonding. It was easy to make the bed when a fun outing was on the horizon!

But there was an even more subtle motivation: Worse than not getting a sticker was being the only one to not get the sticker. How would Devon feel if Crae earned all his stickers and got to go to the mall while she stayed home? That was not going to happen. With that as a consequence, I couldn't stop her from earning her stickers.

In the parenting example, *what moves the child from contemplation to action is an emotional shift*: The task is redefined so that it engages a core strength and motivation. Had I had poor relationships with the kids, the idea of a weekend outing would have been worthless. I also suspect that merely leaving a toy on the table for each child after the chart was filled would have lost its motivational influence. Eventually, you get so many toys that each subsequent one becomes less valuable. It was turning chores into relationship opportunities and the fun of rummaging through bins and finding the right toy that supplied the energy for changed behavior.

Key Takeaway

Without the energy of emotional buy-in, goals are mere intentions.

Most of us make use of this principle without realizing it. If I have to get through boring and onerous work, I will sometimes strike a deal with Margie: If the work is finished by the end of the afternoon, we'll go out somewhere fun for the evening. That creates an incentive—going out is infinitely appealing compared with much paperwork—but it also taps a second motivation. The goal is now a shared one. Margie looks forward to the evening out and, if there's one thing I don't want to do, it's disappoint her. Left to my own devices, perhaps I'd let work expand to fill the time allotted and crawl through the workload by the end of the day. With this new incentive, however, I'm energized to finish as early as possible.

This works because I am substituting a higher, stronger motivation for a lesser one. Often, when we perceive a need for change and action but don't act, it's because we're tapping into the wrong motivations. By restructuring our approach to the activity, we can move the gearshift from contemplation to vigorous activity. Crisis is a powerful catalyst for emotional change, as I found out when I realized I needed to change my lifestyle. *But we don't need to hit a point of crisis to move us to action. All we need to do is tap into a motivation that moves us already*.

See-Feel-Change: The Importance of Optimism

Kotter and Cohen, in their book, *The Heart of Change* (2002), make an important point. They observe our tendency to pursue change through a process of "analyze-think-change." While analysis can help guide a change process, rarely will analyzing and thinking produce the emotional shift needed to move people to a sustainable state of readiness for action. Kotter and Cohen suggest that a more effective change process is "see-feel-change." When we see something that engages us emotionally—inspires us, or perhaps stokes our fear—we feel a sense of urgency and a need to act. Recall the talk given to the call center workers described by Adam Grant (2013). When the workers heard an inspiring story from someone who benefitted from their sales efforts, those efforts picked up materially. A mere process of analyzing and thinking about one's productivity would not have carried the emotional force of that single, short talk.

See-feel-change is crucially important to traders looking to adapt to changing markets. One way to see and feel is to lose so much money failing to adapt that you hit a crisis point and are forced to change

or quit altogether. That is not an attractive option. The alternative is to see and feel something so interesting and promising that it inspires you to research, test, and incorporate it into your trading repertoire. Analyze-think is critical to knowing what to incorporate and what to filter out, but before you analyze-think, it's necessary to see-feel. Without that emotional shift of gears that moves you, the odds are good that you won't move. Recall our couple, Gina and Chris. For years, they did not address their waning relationship. Once they shifted gears and focused on the need to role model something positive for their children, they moved directly into action mode.

In their book, *Switch: How to Change Things When Change Is Hard*, Chip and Dan Heath (2011) provide a useful framework for putting see-feel-change into practice. A very important point that they make is that small wins can set the ball rolling for large changes. It is not uncommon for traders to reach out to me only after they have sustained painful losses and/or protracted periods of failing to make money. By that time, they are discouraged and perhaps contemplating leaving the business altogether. That's a difficult place to be, because discouraged people typically can't muster the energy to overhaul themselves and their practices. You may recall from your college psychology classes, Seligman's classic research on learned helplessness. Rats put in cages divided by a low barrier were exposed to an electric shock on the floor of one side of the barrier. It didn't take long for the rats to jump over the barrier and go to the unshocked side. When placed in a different cage where both sides of the barrier were shocked, the rats would jump, get shocked, jump again, get shocked, and eventually give up on jumping, collapsing on the floor and whimpering. Once the collapsed rats were returned to the original cage, what happened? They didn't jump over the barrier. They learned, Seligman suggested, that they were helpless. They learned that they could not change their situation, so they failed to attempt change even when change was easy to achieve.

This situation is not so different from that of the troubled trader. Like the restaurant owner who sold to Emil, traders give up the business when they no longer believe they can avoid the shocks of market setbacks. When Seligman physically moved the helpless rats over the barrier to the unshocked side, they eventually learned to go over on their own. They needed to see—in their own experience—that their actions could make a difference. The small wins described by the Heaths enable a trader to see that success is possible. That recognition brings a new feeling

and energy. See-feel-change. "When you engineer early successes," the Heaths observe, "what you're really doing is engineering hope."

Traders who contemplate change but cannot sustain preparation and action typically are caught in analyze-think-change mode, rather than see-feel-change. They think about their problems and lament their problems, but none of that builds hope and optimism. Only seeing the possibility of success in a first-hand way provides the emotional fuel to inspire change. Recall the analyses of successful trading I undertook with Maxwell. Was it the brilliance of those analyses that sparked his change? Of course not. He had been lagging in his performance and my analyses merely showed him that he was, indeed, trading very well at times. The emotional recognition that he was trading well even in his slump roused him to look deeper into the sources of his success and do more of what was already working.

The Heaths point out that this is one of the important strengths of a solution-focused approach to change. As we've seen, if a trader is mired in a drawdown, problem-focused talk—endlessly analyzing and discussing what has been going wrong—yields little inspiration value, even if it does bring intellectual insight. That same trader, shown exceptions to the drawdown, suddenly realizes, "Hold on a minute, maybe I *can* do this. Perhaps my situation isn't as hopeless as it seems." Ken Howard and colleagues have studied the process of psychotherapeutic change: how people make changes when they work with a mental health professional. Their research identified a first step of "remoralization" before there was any "rehabilitation." Prior to any behavior change, there was an emotional shift toward hope and optimism.

My work in brief therapy identified precisely such a change trajectory. Reviewing the major approaches to short-term treatment, I found that a common element was what I called a *translation*—a unique perspective from which people could view themselves and their problems. Psychodynamic therapies translate people's problems into patterns grounded in their past; cognitive therapies translate problems into dysfunctional thought patterns, and so on. A curious finding in the psychotherapy outcome literature is that all the major therapies appear to be more effective in generating change than no therapy at all, but none of the therapies appear to be more effective than the others across all people and problems. That has led researchers to propose the idea that perhaps there are common factors accounting for the effectiveness of the therapies. It's not what analysts do differently from behaviorists or family therapists that

contributes to change; it's what all the major approaches are doing that makes them work. One of those common factors is that remoralization described by Howard and colleagues: By translating problems into new terms for a person who feels hopeless and helpless, the therapist helps instill the idea that solutions may indeed be possible. This brings a greater sense of optimism and control. It is not so different from Seligman's guiding the helpless rats to the unshocked sides of the cages.

In that sense, any form of coaching, counseling, or therapy is a method of creating see-feel-change. Through the power of a positive relationship, we learn to see ourselves through a different set of eyes. That new seeing creates a new feeling and an emotional shift of gears that moves contemplation to action.

Key Takeaway

To feel differently, you must see differently.

So let's go back to our exercise and the questions you were asked to answer. If you did not write down your responses per the instructions, does it mean you're lazy or disinterested in change? Not at all. It means that the way you are currently seeing your situation is not generating the feeling—the urgency—needed to move to action. It's going to take an emotional shift of gears—either a jolt of fear or a burst of hope—to move you to action.

As I've been writing this, my Siamese cat Naomi has been by my side. She uses my computer bag as a bed, so she spends a lazy afternoon in the bag while I type away. Once in a while I pet her or call to her, but she pretty much keeps eyes closed and remains at rest. Suddenly, a fly came buzzing by the kitchen island where we were sitting. Naomi immediately raised her head and watched the fly. She tensed her body, leapt off the island, and pursued the new moving object. She is now sitting behind me, along the window wall, intently watching for the fly. In a moment, she was transformed from slumbering, lazy animal to action-oriented huntress.

Seeing this, my mind goes back to our initial adoption of Naomi as a traumatized kitten. It was a pathetic spectacle when we took delivery

of the kitten in a crate. She was cowering at the far corner, literally shaking. We never found out what had happened to her, but we strongly suspected someone had mistreated her. She was intensely afraid of people—anyone.

It became a real problem when we brought Naomi home. She cowered under furniture, scampered into rooms where she could be alone, and did everything she could to keep herself hidden. On those occasions when we could get close, she shook violently. This was more than fear—it was terror.

The first piece of progress came when I went into the bathroom with Naomi and closed the door. There was no place to hide, so she leaped up onto the window sill and slipped behind the curtain. I quietly went over to her and touched her, then retreated. After doing this many times, I was able to get her to the point where she no longer shook. She accepted food from me and that became a way to get her out in the open.

The breakthrough occurred when Naomi was on the bed, enticed by food. I put my hand under the cover and moved it around and—just as with the fly—Naomi's eyes got large. She arched her body and went after my hand. She was so intent on hunting the moving thing under the bedcovers that she forgot to be fearful!

That's when I realized that our newest household member had taught me a valuable lesson about change. When we are in our normal state of mind and body, acting on our normal motivations, nothing changes. When everything is normal, our behavior gravitates to our norm. *If, however, we can substitute a stronger motivation for the one that leaves us passive, procrastinating, or troubled, the fresh energy sparks behavior that previously had been elusive*.

When I worked in a community mental health clinic in upstate New York, I met several veterans of Alcoholics Anonymous who had hit bottom and emerged with a deep religious faith. This was not a gradual, planned process. Rather, it came as a blinding insight, more like a revelation than a reasoned conclusion. So powerful was this feeling of being touched by the Lord that it literally reorganized thoughts, feelings, actions, and priorities. Desires to drink did recur, but now in the context of a far more powerful set of desires and commitments. What broke the cycle of contemplation, initial change, and relapse was a greater motivation that supercharged the desire for sobriety. Like Naomi, who found her way out of fear by engaging the more powerful hunting instinct, these alcoholics overcame addiction with a more profound spiritual attachment.

Now we can see the wisdom behind the Heaths' idea of small wins. The slogan in A.A. is "one day at a time." If you can maintain sobriety for a single day and work your steps to start rebuilding your life, perhaps you can do it for another day, and another. Recall the shift in my exercise routine when I opened the downstairs exercise area to the cats. What had been a solitary activity now tapped into a playful motivation with my four companions. That change started as a small win: a single experience of enjoying interspersing my exercise with my time with the cats. That small win gave motivation to repeat the experience and soon a new habit pattern was born. Small wins are catalysts; they are shots of hope and optimism. Once they spark action, action can become habit—and that is what sustains change.

The Dangers of Trader Isolation

Notice a common thread among the see-feel-change strategies: *Most of them involve interacting with someone or something new*. In counseling, it's the relationship with the helping professional that creates the translation that helps a depressed person see, "*Hmmm* ... maybe it's not that I'm a bad person; maybe I've just learned a way of thinking that makes me feel that way." In Naomi's case, it was interacting with me in a way that allowed her to be the huntress and forget her fear of people. Without the fresh interactions, it's all too easy to stay mired in old ways of seeing and feeling. New experiences enable us to experience ourselves in new ways.

One of the themes I've emphasized on the blog is that *everything we do and everyone we interact with is a mirror*: a way to experience ourselves. A profound romantic relationship or deep friendship is powerful in part because it provides us with an affirming experience of self. Over time, immersed in love, we internalize the sense of being lovable. Similarly, troubled relationships present us with negative and distorted self-experiences: Think of the damage done by abusive relationships on children. When we engage in an activity, we perceive ourselves through the mirror of our experience. More mirrors—and better mirrors—create more opportunity to shift emotional gears. That is why travel to a new culture can be so powerful—it's a fresh lens for seeing self and world.

Trading can be a tremendously isolating experience, even on a large trading floor. The majority of the trading day is spent following markets, researching ideas, and reviewing performance. Screen time inevitably exceeds time spent in significant interaction with others.

While social media has opened the door to frequent contact among traders, the majority of interactions are too brief to serve as effective mirrors. Without fresh social interaction and novel activity, traders lack the mirrors that could catalyze see-feel-change. Change requires fresh inputs; people don't move from contemplation to action by mere reflection alone. The isolated trader all too often is the static trader, caught in doing the same things—even when those things stop working.

The potential for trader isolation is a major reason I have emphasized the importance of networking. Networking—meeting up with other traders and "talking shop"—has the potential to turn see-feel-change into a vicarious process. When we see other traders encountering success through their ideas and applications, that mirrors to us what is possible—and can provide a meaningful emotional gear shift. At a recent networking event that I helped organize, a trader described how he was approaching the market, trading a very limited set of tested patterns. To be action-worthy, those patterns had to occur at particular times of day, with a threshold level of market participation (volume). His idea immediately sparked a thought that I could qualify my own market indicators by the context in which they occurred. This ultimately led to a new line of research that I utilize to this day in my trading.

What is psychologically significant is that this interaction during the networking filled me with the motivation to pursue a new idea. Through the experience of the trader, I saw that something was possible in my own trading—*and I couldn't wait to get home to test it out*. There was no dawdling between contemplation and action: Hearing of the trader's success was so energizing that it led directly to action. Had I been isolated, that experience could never have happened.

The beauty of positive mirrors is that they spark change without the need to go through crisis. Fear is a great motivator; hitting bottom can be a most effective catalyst for change. But hitting bottom in trading can mean going broke. The game is over before change can occur. The positive mirrors created by networking with the right people bring change through inspiration, rather than fear. In sharing someone else's small wins, we experience those vicariously as wins for ourselves. That sparks optimism, inspiration, and the drive to make change happen.

Key Takeaway

It is better to move to action through inspiration than desperation.

Indeed, we can think of networking as a group-based solution-focused intervention. Imagine a group of talented traders, each sharing best practices. One person's ideas spark ideas for others, which in turn lead to new directions and fresh possibilities. Each person's small wins contribute to the discussion, which ultimately becomes about winning. This in turn mirrors to each participant the sense of being part of an adaptive, winning group. Networking is a powerful tool for overcoming the limitations of isolation, as each conversation provides a potential see-feel-change experience. By expanding the quantity and quality of our mirrors, we generate an ongoing source of energy for launching ourselves beyond contemplation, into action.

Changing the Internal Dialogue

A small win is a small mirror. It reflects a winning image to us. Accumulate enough small wins and that winning image starts to become familiar. We internalize that which we experience repeatedly. That's one of the reasons positive emotional experience is important, per the research of Barbara Frederickson's lab. Positive experience broadens the scope of our thinking, which in turn helps us build new experiences and skills. Broaden and build is not so far from see-feel-change. When we experience small wins, we perceive our ideal self, and that inspires us to new efforts.

Recall Charles Duhigg's insight that change is a function of habit creation. It's simply too exhausting to rally ourselves through motivation every time we need to shift contemplation into action. Much more efficient is the creation of action patterns that activate automatically with the right cues. People I've known who are particularly adaptive have made small wins a habit pattern. They undertake many new challenges and regularly define meaningful, doable goals. They set themselves up for success. Positivity becomes a habit, a lifestyle, making the whole issue of discipline moot.

Suppose, however, negativity becomes our habit pattern. Instead of positioning ourselves for small wins, we set ourselves up for repeated failure. We internalize repeated experience, so over time we internalize a sense of failure. Eventually, like Seligman's rats, we find no escape and collapse in helplessness, unable to control the outcomes that matter most to us. That keeps us frozen in contemplation, unable to sustain action.

How do people get into such a state?

Depression is the most dramatic example of circular negativity. As cognitive therapists have emphasized, depressed people process information with negative biases, viewing the world, so to speak, through inverted rose-tinted lenses. Imagine two traders finishing the day with a moderate loss. One sees the opportunity to add to positions at better levels; the other throws his hands in the air and wonders why he trades like an idiot. The latter is a version of depressive thinking, interpreting events with negative self-attributions. Cognitive therapy is effective in part because it helps depressed people think about their thinking. If you can show the depressed person that he would never say to others what he is saying to himself—he wouldn't tell a trading buddy he's trading like an idiot after a losing day—the changed perspective helps shift the way of thinking. It's the equivalent of Seligman taking the helpless rat and plopping him over the barrier to the unshocked side of the cage. If you can talk to yourself the way you've learned to speak to others, perhaps you can break the cycle of interpreting outcomes as small failures.

Depression and its cognitive treatment illustrate the degree to which we create our own realities through our internal dialogues. Many times we fail to move from contemplation to action because our negatively skewed information processing generates more helplessness than empowerment. We don't need to be clinically depressed to fall prey to such negative thinking. Many traders are competitive by nature and become frustrated when they lose money or make poor decisions. That frustration can be channeled externally ("These markets are manipulated!") or internally ("I can't do anything right!"), but in both cases the channeling is not constructive. It doesn't help a person learn from the situation and move forward in a positive fashion. It doesn't naturally lead to small wins. Indeed, by emphasizing a victim mindset—bad things happen to me—such thinking systematically disempowers a trader. If you are the victim of bad luck, bad markets, and bad trading, how can you become the author of your own turnaround story?

One of the habit patterns most important to cultivate as a trader is the ability to lose in a way that gives you energy, rather than robs you of initiative. Of course, losses will be frustrating to a competitive trader, but frustration need not be paralyzing. If you have built a process whereby you routinely look for mistakes and turn them into fuel for self-improvement, you have turned the transition from contemplation into action into a habit. Every mistake is an opportunity—and an obligation—to do something different, something better. Less-than-ideal trading becomes a trigger to work on your ideal self.

Half of the battle is catching yourself in the act of becoming mired in frustrated self-talk. This is why cognitive therapists encourage people to keep journals of their thinking. By writing down what is going through our heads, we can become more objective about the things we tell ourselves. At times, I've also had traders voice their thinking into a recorder and then listen to themselves rant. As a listener, the traders can see that what they are saying is not helpful, which helps halt the process. It is not enough, however, to halt the negative thinking. We need positive habit patterns that shift negative thinking into constructive actions.

Larry was a young developing trader working under a senior money manager. At times he felt overwhelmed by his learning curve and worried that he would never meet his mentor's expectations. This was particularly upsetting, because he respected his mentor immensely. No matter how many times the mentor assured Larry that he was progressing well, Larry found himself worrying about whether he would ultimately be good enough to manage money on his own.

Worry is a form of negative thinking different from depression. Depression tends to be backward looking, blaming the self and casting doubt on the future. Worry is forward looking, anticipating that bad things will happen. The depressed person says, "I can't." The worried person says, "I'm afraid to try." A common observation among traders is that worry can lead to problems with "pulling the trigger" on sound trade ideas. More psychologically attuned to potential loss than reward, the worried trader takes the "safe" route and fails to act.

That was the problem bedeviling Larry. He found himself so concerned about losing money that he either traded very small or didn't trade at all—even when he identified his ideas as being sound. It was as if he were two different people: one seeking opportunity in his market research, the other avoiding market loss in his trading. Over time, this created considerable frustration, as he realized he was not living up to his potential. On one especially frustrating occasion, he told me about his well-researched idea to buy the currencies of strong emerging-market countries. He cited positive economic fundamentals in those countries and liked the fact that the positions were "positive carry": because of interest rate differentials, he would get paid to own the positions. When the currencies opened higher the next day, he told himself he would buy a pullback. When they extended their gains, he told himself he would

not chase the move and buy at bad levels. When the currencies closed the day sharply higher, he felt completely stupid, failing to act on an idea that he had pitched to others. Nothing is worse, he remarked, than getting calls from others congratulating you on your trade when you never put it on in the first place!

Larry had plenty of ideas for improving his trading and putting on good trades. His problem was that he could not move from idea to action. What inhibited him was his thought process. As long as he saw the threat of losing as greater than the threat of not acting, he remained paralyzed. A turning point for Larry came when we realized that his love of generating ideas was what really motivated him in markets. The trades simply were ways of seeing ideas work out. He loved the process of coming up with market views that escaped others—and he took justifiable pride in his work. At one point I encouraged him to write down in advance, not why he should or shouldn't take the trade, but why he should act on or betray his research. In other words, we reframed his worry pattern as one of self-sabotage. Understandably, he had never thought of holding back on implementing ideas as a betrayal of his life's work, but his reaction to the thought was visceral. He would never want to betray his best work; else, why do it? Through that reframing, he was able to move to action, because he now viewed inaction as a risk far greater than losing money.

Larry's worry problem is especially common with respect to fear of the unknown. There is no guarantee that change will be successful; sometimes familiar troubles feel safer than unfamiliar, unexplored territory. This is where small wins become extremely important. If the change process is ongoing and evolutionary, there need be no fear of revolutionary change. Traders often will try something new in small size and just see how it works over time. Several traders I've worked with have segmented their books into different strategies, with the more experimental strategies taking fewer positions with less risk. It's a way of testing ideas in a nonthreatening way. If the ideas are good, they generate the small wins that can lead to a scaling up of the strategy.

Key Takeaway

When change is threatening, small changes can inspire further action.

As we will see shortly, however, there is a big difference between making changes and sustaining those changes. Viewing his thought process

in a new light helped Larry make a change, but he needed to turn that new view into a habit pattern in order to keep the change going. By writing down the pros and cons of betrayal each day for a number of days, and actively mentally rehearsing how he would feel if he let himself down, Larry was able to internalize the change. He did so, not by becoming a different trader, but by doubling down on what had brought him to trading in the first place. It's back to our experience with Naomi, the traumatized kitten: Find a motivation greater than the motivation powering the problem and change can occur naturally.

The Perils of Perfectionism

Depression and the worry of anxiety are two modes that keep people from change. Very often those represent ways of channeling frustration. There is another cognitive pattern, however, that is less recognized as a problem than either of those: perfectionism. As I have noted on the TraderFeed blog, perfectionism masquerades as a virtue. The perfectionist prides himself on being driven and not accepting anything less than the best. He justifies perfectionism as motivation, as if the only alternative were complacency. In reality, however, perfectionism destroys motivation. It is a formidable barrier between contemplation and action.

The stark truth is that perfectionism is driven by insecurity. The motif of the perfectionist is "not good enough." It doesn't matter if you made money today or this week; you left something on the table and could have made more. If you had several winning days and a losing day, it's the losing day that gets the focus—and the frustration. *Over time, the message that your efforts are "not good enough" creates small defeats, the opposite of small wins*. Perfectionism can take winning experiences and turn them into losers. The response I often hear from perfectionists when I offer them positive feedback is, "yes, but." There is always something they could have done better, or something they failed to do.

The easy way to see that perfectionism is destructive is to simply imagine yourself speaking that way to your trading buddies or your own children. If your little girl came home from school with two As and a B, are you really going to launch into her for failing to get all As? What would be the result for your relationship with her? What would be the result for her self-confidence? Repeated experiences that this isn't good enough and that isn't good enough eventually mirror the sense that *you're* not good enough. The measure of so many things in life is whether they

give energy or drain it. It's a great filter for the people in your life, the activities you engage in, and the work you perform. Perfectionism drains energy. It does not inspire performance; it turns inspired performance into something "not good enough."

The idea of small wins means that your focus should not be on perfection, but on improvement. This is why the right kind of goal setting is so important. Research from Locke and Latham suggests that goal setting is effective in changing behavior. Their work finds, however, that when goals are too difficult or threatening, they tend to not be effective. Perfectionistic goals, by definition, have strong odds of not being met. Instead of creating wins, they pose the threat of failure. When goals are framed in terms of improvement—challenging and yet doable—they are much more likely to inspire.

I cannot emphasize strongly enough: *We internalize repeated experience*. Our internal dialogues frame our experience. When we frame life events in negative ways, we create drains on our energy that keep us from adapting and growing. Constructive, positive framings are important because they keep us experiencing ourselves in ways that give energy. Perfectionism attempts to push behavior from behind with the threat of failure. Inspiring goals pull behavior from a positive vision of the future.

Relapse

As I mentioned earlier, initiating change is only part of the battle. Another part is sustaining change. Prochaska, Norcross, and DiClemente, in their book, *Changing for Good* (1994), stress that relapse is a part of the change process. We rarely make changes in straight lines, where we take new actions and leave past patterns forever. Rather, change is a bit of "two steps forward, one step back." Many of our patterns have been with us for years; they are well-engrained habits. It is easy to fall back into them.

Relapses tend to occur during periods in which we lose mindfulness. Mindfulness is a state in which we are self-aware, as emotionally neutral observers to ourselves. When we are in a mindful state, we don't react to situations; we observe ourselves responding to situations. A good example would be going out to eat when I'm on a diet. I'm aware that there will be many foods available and that people around me will be eating. I prepare myself in advance and decide that I will only eat the healthiest options, and in moderation. That self-awareness enables me to sustain my longer-term intention.

Baumeister and Tierney's research on willpower (2011) suggests that people in general are not good at forgoing short-term temptations and acting in their longer-term self-interest. When people perform an effortful task and then are placed in front of tempting foods and told to not eat them, they are much less likely to resist temptation than people who have not performed the task. This suggests that willpower is a finite resource in the short run. When we expend energy in intentional action over a period of time, our willpower muscles become depleted and it's easy to fall into reactive patterns. This is a very important concept. As Kelly McGonigal points out in her book, *The Willpower Instinct*, "Our brains mistake the promise of reward for a guarantee of happiness, so we chase satisfaction from things that do not deliver" (2012, p. 132).

McGonigal's (2012) distinction between reward and happiness lies at the heart of many relapsed efforts at change. What would make us happy is losing the weight. What feels rewarding is eating from the dessert tray at the party. The problem is that what is rewarding ultimately does not bring us happiness and, indeed, can sabotage our longer-term satisfaction. Most traders know what happens when they get caught up in short-term market action and enter a position they would never contemplate had they engaged in mindful planning. The promise of quick reward from a short-term trade temporarily overwhelms the longer-term happiness of following a sound business plan for one's trading.

One of the psychological factors that depletes our willpower is negativity. When we make ourselves miserable with self-blame and worry, it is much easier to seek solace in immediate reward. Such negative thinking robs us of energy, and that robs us of willpower. Conversely, it is much easier to stick to a diet or a trading plan when we concretely see the benefits coming to us. And, of course, once a new behavior pattern becomes a habit, it no longer takes willpower to sustain it.

How can we overcome negativity and the psychological leaks that drain us of willpower? It turns out that research on mindfulness meditation is quite relevant to the prevention of relapse. Research from Teasdale and colleagues (2000) found that mindfulness-based cognitive therapy was significantly effective in preventing relapse among people with major depressive disorder. Mindfulness practice has also been found to confer health benefits, stress reduction, social connectedness, and improvements in concentration. The reason for this is that mindfulness allows us to become neutral self-observers, rather than caught up in the frustrations of the moment. Consider the difference between the person who says, "I'm a total failure; I can't succeed at anything!" and the

person who says, "Now I'm telling myself that I'm a total failure and that I can't succeed at anything." The first person identifies with the negative message. The second person takes a self-observing stance—not just thinking and feeling, but being consciously aware of how they're thinking and feeling.

By quieting the mind and body, perhaps by focusing on deep, regular breathing, meditation places people in a state that is incompatible with emotional arousal. When a stressful event occurs, we respond with fear or frustration and our bodies go into overdrive, preparing us for fight or flight. Part of that overdrive involves the blood flow shifting to the motor centers of the brain and away from the executive centers that facilitate our planning and reasoning. This is why I mentioned in my earlier books that worked-up traders are literally out of their minds. They analyze and plan their trades with the frontal cortex activated and then, in the heat of market action, act out of the fight-or-flight responses of their motor centers. In his excellent book, *The Hour Between Dog and Wolf* (2012), John Coates explains that these shifts are mediated by chemicals within the body, which promote risk taking (testosterone) and reacting to stress (cortisol). As a former trader as well as a neurobiologist and economist, Coates makes a powerful case that many of our actions in the heat of battle are more biologically than logically driven.

Key Takeaway

Our emotional state generally follows our physical state.

Relapse tends to occur during overheated periods, when we are least mindful. It is one thing to maintain sobriety while at A.A. meetings, focused on helping ourselves and our peers. It is something very different to maintain sobriety when we are sad, angry, or anxious. Once willpower drains, we fall back into old patterns—and all too often lack the self-awareness to arrest the process. Prochaska, Norcross, and DiClemente, in *Changing for Good*, cite research that finds 60 to 70 percent of all relapses in drug and alcohol, smoking, and eating behavior are preceded by emotional distress. It is when we are taxed by upsetting situations that we are most likely to lose willpower and mindfulness and act on autopilot.

Kevin was a skilled daytrader I worked with early in my career. Most of the time he was workmanlike in identifying buyers and sellers in the depth of market screens. He also displayed unusually good risk management. He could take a loss, step back, figure out what went wrong, and continue trading without becoming caught up in stress reactions. Every so often, however, Kevin would experience large, painful trading losses. At those times, he would trade extra-large size and hold positions that went against him far beyond levels where he would ordinarily stop out. Ironically, when he was trading his normal size, he was diligent and religiously adhered to his stops. It was when he was largest—and hence most vulnerable to outsized drawdowns—that he became stubborn.

At the time I began working with Kevin, he had undergone a painful drawdown. The owner of the trading firm made it clear to Kevin that either this behavior had to stop or else Kevin would be prevented from trading significant size. As Kevin and I talked, it became clear to me that he was not operating with a hidden self-sabotage wish, nor was he impulsive or imprudent as a person. It was at times of maximum confidence that Kevin would trade his largest size. Convinced that he was right in his view, he would allow trades to move far against him before admitting defeat. *It was not the distress of losing money but the euphoria of being on a hot streak and having a promising idea that nudged Kevin out of mindfulness mode*. That was an eye-opener for me: It showed that *any* form of emotional and physiological arousal—not just the emotions of distress—can put us "out of our minds."

I used the emotional thermometer exercise with Kevin, where he had several sheets of paper in front of his trade station each day, printed with a picture of a thermometer. During the morning, midday, and afternoon he had to "take his emotional temperature," indicating how "hot" or "cool" he was. Key to the exercise is that we clearly identified excitement and confidence as "hot" states. The thermometer was a device that helped Kevin become more regularly mindful of how he was feeling. Once he explicitly identified that he was hot, he could take corrective action to cool down.

The simple mindfulness exercise that we performed to help Kevin cool down was a deep, slow breathing with eyes closed. With each breath, he told himself that he was cooling down, becoming more and more chilled. His sole focus was on his breath and the self-suggestion. On his own, Kevin modified the exercise to simply repeat to himself the word "chill" with each inhalation and the word "out" with each exhalation, in the manner of a mantra. This quieted him in mind and body and placed

him in a state where he became very sensitive to how he was thinking and feeling. Whenever he started to get excited, he simply closed his eyes for a moment, took a deep breath, and reminded himself to "chill ... out." He found it much easier to act in a desired way when he was in a cognitive, emotional, and physical state that kept him mindful. *Relapse requires mindlessness*; if you are not operating on autopilot, you have the opportunity to steer yourself.

Summing Up: Moving from Contemplation to Action

We began with a short exercise to answer questions regarding your approach to adapting your trading to evolving market conditions. One purpose of the questionnaire was to assess your readiness for change. Many readers will have skipped the completion of the questionnaire or only jotted down or mentally noted very general and generic responses. Most traders are aware of the need to keep up with changing markets, but few take purposeful, directed action toward adaptation. By the time the need for change is painfully apparent, much damage can be done to one's psyche and one's trading account.

Two motivations move people from contemplation to action: fear of negative consequences and the inspiration that comes from visioning positive and possible outcomes. If you have been contemplating change for a while but remain in a personal or trading rut, you are operating somewhere in emotional limbo between those emotions: not feeling the fearful imperative of the need to change, and also not feeling the inspiration to move to the next level of your development. Only an emotional shift can nudge you to action; routine trading by following daily routines can never take you out of limbo.

When you have a sound trading approach that is working well, sticking to a disciplined routine makes all the sense in the world. When that approach is no longer working, sticking to that same routine keeps you from adapting. The idea that successful trading must tame our emotions makes sense when we're making decisions in the heat of battle. Less appreciated is that we must *amplify* our emotional experience to move from status quo to a new and positive equilibrium.

When I lost weight and got myself in better physical shape, two emotional shifts made a big difference. Having my cats become part of the downstairs exercise routine, as mentioned earlier, was helpful in

developing a fresh habit pattern. I've consistently found that turning an activity from an individual one to a social one creates a fresh emotional experience. As a college sophomore, I was pleased with my academic development but felt I was not as socially well developed—or confident—as I wanted to be. So what did I do? I signed up to serve as the social director for our dormitory hall. Stronger than my social reticence was my desire to not fail in an undertaking where people were counting on me. As I poured myself into organizing parties and reaching out to other halls, I found that I not only enjoyed the social experience, but was pretty good at it. Recall how the traumatized kitten Naomi overcame her terror at the sight of people. Once I played with her by moving my hand under the bedcovers, her hunting instinct took over. She pounced on the hand and joined in the game, forgetting her fear altogether. Tapping into our strongest motivations and values helps us make similar shifts. I might not take action to go to the gym when left to my own devices, but if I make a commitment to a friend doing physical therapy, there's no way I'll fail to show up.

The second force that prompted me to lose the weight and get back into shape was simple, sheer disgust. I stepped on the scale and the needle hovered near 200 pounds. My clothes weren't fitting as well and my energy level was at low ebb. I was drinking too much coffee, eating too much, and working long hours that I used to justify not exercising regularly. When my energy level was drained and I stepped on that scale, change no longer felt like an alternative; it was now an imperative.

At some point, most of us care enough about ourselves that we will not allow negative consequences to accumulate indefinitely. You might not pursue change because you're losing money, but you will embrace change once you're sick of losing money.

Years of working in proprietary trading firms, banks, and hedge funds have taught me that there are two types of trader: one who is drawn to trading for negative reasons; the other who is drawn for positive ones. The person who is drawn to trading for negative reasons is looking for an escape. Perhaps it's an escape from working an 8-to-5 routine; perhaps it's an escape from working for someone else; perhaps it's an escape from past failures and shortcomings; perhaps it's an escape from hard work. In all those cases, trading is the playing out of a fantasy—the hope that it will be possible to be maximally successful with minimal effort.

Those drawn to trading for positive reasons find in trading an ideal fit of values, skills, and interests. Trading becomes an expression of their identity—an exercise of their strengths, not an avoidance of their vulnerabilities.

You can tell what kind of trader someone is by how time is spent outside of market hours. The trader with a positive source of motivation has an interest that goes beyond the thrill of putting trades on and making/losing money. The positive source of motivation might be the intellectual curiosity of understanding a global macro picture; the satisfaction of discovering new relationships driving markets; the mind-broadening of sharing ideas within a network of colleagues; or the fulfillment of working on improving one's performance. In each case, the motivation does not fade when markets aren't open or when they are not providing profits. For the trader whose motivations are primarily avoidant and negative, there is little appeal to markets outside of the immediate experience of putting trades on and making money. Because they are looking to markets for self-validation, there is nothing to be gained when markets are closed.

This distinction is crucial, because it once again suggests that an important way to shift from contemplation to action is by tapping into core motivations and generating the emotional shift that they can provide. When my trading has stagnated, nothing works better than taking some time away from screens and going into idea-generation mode. I certainly enjoy being profitable, but what is particularly satisfying is generating a fresh idea that brings profitability. Stepping back from trading and opening my mind to new perspectives recharges the batteries and energizes me to make the changes I need to make in markets out of a desire to make the most out of those new ideas.

Recently I found, however, that even the hunt for new ideas was not getting me past a trading block. I examined my trading and found a pattern. After taking some time away from markets, I would get a big idea, trade it, and make good money. I would then place subsequent trades and lose money. That led to taking time away from trading and generating new big ideas. The cycle got to the point where I found it difficult to rouse myself to stay engaged with markets. That surprised me, because I normally don't find myself demotivated. I spent more time with my research, but that did little to spark my trading interests, also something that was surprising.

It suddenly hit me that what I most loved about markets was not analysis, but the synthesis of all I had analyzed. It was coming up with that big idea. That was what I was good at—not breaking the market down, but compiling information into a coherent scenario. When I was

in synthesis mode, I generated overarching ideas and did quite well with them. When I became too granular and attempted to trade patterns in my analysis that were devoid of a bigger picture, I was net unprofitable, but also less engaged. My core motivation was not just the scientific one, but also the creative one: I love looking at a broad range of analyses and then synthesizing them into ideas that bring opportunity.

Key Takeaway

Moving closer to our strengths can provide the emotional shift needed to take action.

That recognition led to a very important change in my trading process. With the help of the Evernote app, I began writing out my market ideas, using the writing to synthesize all I had been observing and researching. The writing was fairly stream-of-consciousness and not intended for any audience. Not only was this enjoyable; it also led to important insights. Connections I would have never perceived simply by thinking in the abstract came to light when I was in writing mode. By shifting myself to an information-processing strength—writing has always been a native mode of thinking—I was able to create a rhythm between idea generation and trading. No trade could go into the book without time for synthesis; all trading had to reflect big ideas. In a relatively short period, I moved from being demotivated to taking significant action.

Let's say my underlying motivations for trading came, as Maslow would say, more from deficit needs than the actualization of strengths. Perhaps I had not been successful in life and now needed markets to make me money or validate me as a person. Perhaps I was not getting gratification and excitement in various parts of my life and needed markets to fill the void. In such a situation, once I had gotten into my trading rut, there would have been little to pull me out. Indeed, the pattern of making and losing money might have proven so frustrating to my unmet needs that, instead of revamping my process, I might have gone on tilt and traded out of frustration, creating larger losses and wounding myself further.

Trading can be quite exciting, and it can be quite profitable. Those, however, cannot be your primary motivations for engaging markets.

There will always be low-volatility markets that are not exciting, and there will always be periods of drawdown. Thrills and profits will carry you through the good times, but leave you nothing to draw on during lean periods. When markets change profoundly, the work of rebuilding one's trading is neither exciting nor immediately profitable. The traders I've known who have sustained long-term success have always been driven by something beyond immediate excitement and profitability. Very often, those drivers have reflected core strengths and interests that provide energy, even when markets are not paying out. It is that energy that catalyzes the transition from contemplation to action. We don't operate in limbo and autopilot if we are tapping into our most profound values and capacities.

Taking and Sustaining Action: Identifying Opportunity

Let's go back to that earlier questionnaire and review the actions you are pursuing to adapt to new and challenging market conditions. As with any strategic review of a business, the questionnaire is designed to tap into your perceptions of both opportunities and threats in markets. How can you pursue opportunity and avoid threats in the next several years? If you did not answer the questions earlier, please now jot down your best responses:

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Self-Assessment Exercise

- How, specifically, do you expect your markets to evolve over the next several years?
- Where, specifically, do you perceive the greatest areas of opportunity in your markets over the next several years?

- What, specifically, has been the greatest source of threat to your trading in the past year?
- How would you need to change your trading to keep pace with the shifts in markets, opportunities, and threats noted above?
- What are you doing now, on a regular basis, to master the learning curve needed to exploit the opportunities and avoid the threats you foresee?
- What new markets or market information are you examining in detail to help prepare you for the future?
- If you don't have clear, specific answers to the above, with whom do you need to speak and what do you need to research to gain clarity?

Now that you've answered the self-evaluation questions, let's take a look at those responses and their implications. We'll start with the answers to the first two questions: How do you expect markets to evolve and where do you perceive areas of greatest future market opportunity? If you are like many traders, your responses are more general than detailed, extrapolating the clearest, most recent trends into the future. Perhaps you responded by saying that an increasing proportion of trading would be dominated by computers or that large financial institutions would grow at the expense of smaller ones and individual investors/traders. While those trends may well continue to be the case, they don't represent new information. Today's success stories are those who recognized those developments a decade or more ago, as they were gaining traction—not once they were firmly established.

Strong answers to these questions, on the other hand, elicit an "aha!" response from knowledgeable market participants. A while ago, I observed that a growing share of trades among large, discretionary traders was conducted via execution algorithms. As I spoke with those who used and developed these algos, it became clear that most of these leave distinctive "footprints" in markets. After studying the sequencing of transactions in a trade-by-trade time series, I could identify with a meaningful degree of accuracy whether buyers or sellers were executing with particular urgency at any point in time. Aggregating this information led to promising measures of buying pressure and selling pressure that provided insights not possible when viewing traditional price and volume charts. Those analyses profoundly shaped my view of markets. They provided more than an improvement on my old perspectives; they represented a wholly fresh perspective, not unlike Emil's vision for the restaurant.

Two elements contribute to clear visions of the future: new observations and new information. In the previous example, the new observations came from studying execution algorithms and their transaction patterns. The new information came from transaction-level data. As I commented to a colleague at the time of my study: "Everything of interest is occurring within the one-minute bar." Quite simply, I was seeing markets differently because I was looking at different market data. Emil's adaptation to the future was similar: His study of diners and their favorite restaurants led to new observations. His tablet-based ordering system generated consumer preference data that simply had not existed when ordering was conducted manually, via wait staff and printed menus. If you're looking at the same things in the same way—making similar observations and relying on similar data—the odds are strong that you'll remain mired in status quo views, hampering any efforts at adaptation. *To do new things, you have to be looking at new things*. New observations spawn new questions and those can generate fresh answers.

Imagine executives at companies like Samsung or Hyatt responding to the first two questions in our exercise. The odds are high that they have been studying consumer trends and preferences in smartphones and travel and have a strong sense for how their markets are likely to evolve. They collect data on their customers; they conduct focus groups; they study retail and lifestyle trends. Fresh observations at Samsung may reveal emerging demographic trends that will necessitate a more radical integration of computing and mobility, as phones become part of a *quantified self* revolution. Hyatt's studies may lead to the recognition that aging Baby Boomer customers with discretionary income are gravitating toward convenient, all-in-one destination resorts that provide unique adventures and cultural experiences amidst the usual amenities. Such insights enable the companies to actively pursue the future, even as they succeed in the present. How long would they stay in business if their responses to the first two questions above consisted of a couple of sentences, filled with vague generalizations?

One of the best ways of answering the first two questions is to see what has been working in markets and what has not, including who has been making money and who has not. As I write this, one of the most common assumptions I have heard from traders and investors is that the "financial repression" imposed by central banks—the holding down of interest rates and continued purchase of government debt—will unwind and result in bear markets in bonds and stocks. That may eventually occur, but operating from that framework blinded investors to meaningful returns in segments of the stock and bond markets over many years.

By tracking the returns of who has been making money and who hasn't, it's possible to see what the winners are doing differently from the losers. This, too, is one of the great benefits of networking. Talking with experienced traders reveals their best practices, some of which can be incorporated into your own. Going into discussions with traders with an eye toward reverse-engineering their success is a great way to figure out adaptations that could be useful to your trading.

Key Takeaway

You are most likely to sustain profitability if you study the successes of others.

Sometimes opportunity can be identified by looking at markets in unique ways. For instance, focusing on relative performance—how some stocks, regions of the world, or currencies are performing relative to others—we can generate ideas that would not be apparent if we were to focus solely on outright price. Fresh opportunities can be found in patterns of volatility and among stocks that have little institutional following. At the time of writing this, large capitalization shares are underperforming smaller capitalization ones due to the differential impact of US dollar strength on large exporters versus small domestic firms. Learning to view markets through multiple lenses helps us make key adaptations in our trading, as one theme wanes and another waxes to take its place. As we shall see later in the book, this is a major reason why creativity is essential to adapting to changing markets.

Many of us search through markets to see what they're doing. Not as many of us re-search those markets, studying their patterns in a rigorous manner. When I returned to trading following a hiatus occasioned by full-time work at a hedge fund, I found that markets had changed during my years of absence. Many of the short-term patterns that had been reliable no longer proved profitable, particularly short-term patterns of mean reversion in stocks. This led to an extended period of research in which I tracked the cyclical ups and downs of the stock market. What I found was nothing like what I had expected: The cycles were longer in duration than my past trading embraced and were more related

to such structural factors as volatility, correlation, and sentiment than any particular fixed durations. In other words, cycles appeared in the market, but were aperiodic: They occurred over varying time frames. Interestingly, however, the cycle phases displayed structural similarities that helped me estimate whether we were in rising, topping, falling, or bottoming phases. Only after seeing this research play out in real time did my trading evolve from shorter term to longer, more variable holding periods. Searching led to researching led to adaptive trading practice.

This is one of the great advantages of research: It can generate fresh insights that open the door to new opportunity. From consumer goods companies to pharmaceutical firms, research and development is an important component of adaptation in business. Before automobiles, smart phones, and menu items are launched, they have been extensively researched and tested on multiple segments of the public. A research pipeline does not guarantee success, but the absence of one almost certainly ensures stagnation.

Another important advantage of research is that it taps into some of those core motivations that not only move us toward change, but help us sustain change processes. For the most part, the aforementioned research led me to put aside the shorter-term trading that used to be my bread and butter and focus on larger ideas grounded in the cycle work. The excitement of seeing new ideas play out has eclipsed any regrets I might have felt about leaving behind my former trading. It is the sense of opportunity that drives any entrepreneur: the desire to bring a vision to life. Once operating in that entrepreneurial spirit, sustaining a change process becomes natural, as the work gives energy.

Taking and Sustaining Action: Identifying Threats

It is not enough to identify and act on opportunity; we also must avoid threats to our trading businesses. One trader I worked with was experiencing unusual success trading microcap stocks. He attributed that success to the fact that market-making algorithms were not as dominant in those markets, which permitted a cleaner read of supply and demand. He did very well for a number of months and then, during a risk-off period in equity markets, the microcap market all but dried up. Speculative action in those shares was fine during bull market periods, but was among the first to go when markets traded defensively. Clearly this was a threat

to his business, and he needed to supplement his microcap trading with other sources of opportunity.

Sometimes the greatest areas of opportunity also pose the largest threats. The transition from basic cell phones to smart phones opened phenomenal opportunity, but also imperiled the makers of traditional devices. Exchange-traded funds (ETFs) have created great opportunities to trade a variety of stock market sectors and asset classes in cost-effective ways, but these funds have also contributed to increased correlations that have made long/short investing more challenging. One of the trends I'm currently tracking is social investment. Brokerage firms such as Motif Investing allow investors to purchase baskets of stocks and ETFs to express particular market themes and views, all for a single retail commission fee. The themes and portfolios are shared among investors, who develop reputations and followings for their acumen. It's not difficult to see that this trend enables the average investor to operate as a virtual hedge fund, constructing portfolios across multiple regions of the world, asset classes, and themes. This is a tremendous opportunity for the individual investor, but also a challenge to traditional investment advisers. It's not at all clear to me that people will pay high fees to advisers when they can receive credible, crowdsourced guidance or standardized advice from robo-advisers.

The continued rise of social trading and investing promises to increase the interconnectedness we already observe in the trading world. When I first began work with hedge funds, I was surprised to find how connected portfolio managers were with one another, not just within firms but across companies and across continents. It didn't matter whether I was speaking with a money manager in New York, suburban Connecticut, or London: The same research came up in the conversations and the same positions appeared in the portfolios. Many of the best performing traders were those who were most connected, as they were able to get in and out of positions most nimbly, based on their ability to read the investing herd. Traders who were less connected, particularly older traders not involved in social media to any significant degree, found themselves scrambling when positioning extremes led to mass runs for exits. Connectedness provided an opportunity for some money managers, a threat for others. For example, views and positions become so crowded at times that it becomes difficult for trend-following managers to stick with their holdings, as markets move in violent waves of buying and selling. The

choppiness of market movement, exacerbated by positioning extremes, plays havoc with stops and sound entry execution, making it difficult to keep drawdowns small while riding longer-term moves.

Yet another market threat in recent times has been the crushing of volatility across assets in the wake of activist central bank policies. For a number of years, traders who relied on momentum and price extension for their trading found that such follow-through was missing. This was particularly threatening for traders who tended to scale into positions. Just as they added to winning trades, the markets reversed and took their P/L negative. Of those traders who adapted successfully, some experimented with different entry execution—entering large and progressively scaling out when trades went their way—and others moved to more volatile assets, where momentum patterns were likely to play out. One trader I know has used VIX as a gauge: When it got below a certain level, he pulled back on his stock index trading and instead looked for setups in individual stocks trading above average volume.

What shifts do you need to make in your own trading process to adapt to market changes that threaten your profitability? Among the possibilities you might contemplate are:

- *New inputs*: Fresh fundamental information; new information about supply and demand in your markets; novel perspectives on related markets, including shifts in market trends and themes
- *New markets to trade*: Markets, market sectors, or stocks that appear to be well-positioned for benefiting from the developments you perceive on the horizon
- *New time frames and times of opportunity*: Longer or shorter holding periods to adapt to shifting market conditions; changes in times of day for finding opportunity and executing trades
- *New strategies*: More relative trading versus directional, outright trading; greater emphasis on trading volatility versus price direction; trading of mean reversion/range/reversal patterns versus momentum/trend/continuation patterns

There is so much you can change—in what you follow and how you trade—that the choice can feel overwhelming. How do you decide where to focus?

Many times, the answer can be found in your own trading. This brings us full circle to the solution-focused framework. It is rare that we trade poorly all the time in all respects. Sometimes we make decisions that are more adaptive; other times, we make particularly poor decisions. A careful inventory of where and how you're losing money (and where and how you're making money) will provide you with a particularly useful perspective on threats and opportunities in your trading universe. It was precisely such an inventory that enabled Joe to see that sizing up his positions was responsible for a large proportion of his losses. When he entered a scalp trade in moderate size, he was much more likely to be profitable. That pattern had not been apparent to him before our meetings: He never thought to break out the patterns underlying his successful trades.

Key Takeaway

Many times, you are already making adaptive changes in your trading and not recognizing it.

Yet another money manager had a solid hit rate on his trades and was profitable in most months. Every so often, however, he experienced painful drawdowns that significantly reduced his profitability. More than once, I had the image of the mythical Sisyphus rolling the large stone up the hill only to have it roll back and leave him at the base. When we examined his trading, it became clear that the losses occurred during periods of high market volatility. At those points, correlations among positions increased significantly and what looked like a diversified portfolio no longer behaved as one. Because of those correlations, he was taking much more overall portfolio risk during rising volatility periods than he had realized. By more carefully monitoring volatility trends and adjusting his book to shifts in volatility regimes, he was able to significantly attenuate his losses.

This was a particularly interesting situation because, at the time the money manager engaged me, he assumed that his problems were psychological. From his perspective, there had to be something wrong with his psyche to repeatedly go through cycles of making money and then losing it. In point of fact, however, the problem was more logical than psychological: It was the result of failing to identify and adapt to volatility and correlation shifts in markets. I find this bias to be quite

common among traders: Instead of looking for threats in markets and ways of adapting to these, they assume that poor performance necessarily has a psychological origin. This can certainly be the case, but surprisingly often, it is not. Assuming that trading problems are emotional ones prevents us from taking a hard look at our trading and making needed changes. In my experience, it is just as common for poor trading to create emotional upheaval as the reverse, especially among experienced traders.

In the case of my trading adaptation, the inventory of profitable and unprofitable trading revealed that time was a crucial element. The likelihood of losing money was directly proportional to the frequency of my trading. When I took the time to synthesize my market research and formulate overarching scenarios, I was much more likely to participate in meaningful market moves. When I traded patterns setting up in markets, heedless of a larger context, I inevitably lost money. What seemed like random performance was actually quite meaningful once I pulled out successful and unsuccessful trades. In my case, it wasn't so much emotional factors as cognitive ones that impacted my performance. Markets were moving in longer-term cycles and, if I did not adapt to those and place immediate price action into their larger context, I was likely to be chopped up.

Where to Look for Fresh Directions

Many times, it is not clear to us how markets are shifting, making it difficult to chart an adaptive path. The final question of the questionnaire assesses this issue: Do you know where to look for tomorrow's answers?

This is where networking with traders can be especially helpful. By networking, I'm talking about actually getting together with traders and talking shop with them, not merely exchanging chat messages online. When you spend time with traders, you find out what they are looking at—and also what leads them to shift their focus. This can help you become more sensitive to important changes in economic data, central bank policies, and geopolitics. I recently met with a group of macro strategists who work at hedge funds and expected a lively discussion of monetary policies around the world. Instead, their discussion focused on oil and commodities and factors that were influencing prices. Their emphasis was on inflation versus disinflation within the United States, not on global economics. That made an impression and helped me become more sensitive to interrelationships among asset classes.

Fresh perspectives can also come from reading research in applied finance. SSRN is a particularly fruitful source of research papers that can be downloaded free of charge. Recently, I read a review of momentum trading strategies that I found via SSRN. The work suggested a unique way of looking at momentum that could apply to my own trading. Often when I read such ideas, I will test them out over varying time periods to see if they yield any meaningful predictive value. Usually there's not too much exciting, but once in a while a fresh relationship will emerge. It was just such testing that led me to examine the relationship between realized and implied volatility among stocks and identify momentum opportunities when implied volatility (the volatility anticipated in options pricing) is high relative to the volatility that has actually been realized.

In a broad sense, there are two sources of edge that enable traders to adapt to changing markets, build their businesses, and rebuild them: informational edges and behavioral edges. Informational edges come from obtaining information not widely shared within the trading and investment world when that information holds predictive value with respect to markets. The trader who has access to satellite data to see weather and crop patterns has an informational edge in the agricultural commodity markets. The trader who can aggregate upticks and downticks among all stocks trading throughout the day has a potential informational edge over traders merely looking at bar charts. Many times, informational edges can come from building a better mousetrap. While others look to advance–decline lines for signs of breadth, I track stocks across all US exchanges and the percentage trading above their moving averages. The latter ends up being a far more sensitive—and informative—measure of breadth than the standard indicator.

The other form of edge is behavioral. Participants in markets behave in ways that are patterned. It is often possible to observe those patterns and identify ways of profiting from them. Sustained market advances frequently follow from violent selloffs: When the majority of the public is bearish and defensive, markets often have their greatest upside potential. Similarly, periods of waning breadth, bullish sentiment, and low volatility among stocks typically lead to subnormal returns. The trader who segments market moves based on time of day exploits behavioral patterns among market participants. Similarly, event traders may count on investors to underreact to earnings or data releases that are well off consensus, leading to profitable short-term trades.

To repeat a theme that is central to this book: The majority of experienced traders do not fail because of lack of discipline or an absence

of emotional control. Skilled traders fall by the wayside for the same reason that skilled restaurateurs do—they keep doing what has made them successful until it works no more. Attached to their old ways, they fail to appreciate the opportunities and threats around them. It is not enough to trade today's edge; we must also find tomorrow's. That requires diligence, openness, productivity, and creativity. Can we cultivate those virtues? That is the topic of the second section of this book.

Trading Psychology 2.0 is grounded in the ABCD themes: Adapting to changing markets; Building strengths; Cultivating creativity; and Developing best practices and processes. We've just seen that it is not sufficient to develop an edge and assume that it will last indefinitely. Successful traders learn to generate new sources of edge and incorporate those into their businesses. But how can we not only master markets, but re-master them as well? Adaptation requires building the future on the foundation of our current successes. Understanding our strengths—our talents, skills, interests, and sources of excellence—is essential to defining our future. Our goal is to leverage the best within us, so that we can understand and exploit ever-shifting market dynamics.