Misadventures in Trading

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On the lecture tour following the completion of this book's predecessor, *Market Wizards*, certain questions came up with reliable frequency. One common question was: "Has your own trading improved dramatically now that you've just finished interviewing some of the world's best traders?" Although I had the advantage of having plenty of room for dramatic improvement in my trading, my response was a bit of a cop-out. "Well," I would answer, "I don't know. You see, at the moment, I'm not trading."

While it may seem a bit heretical for the author of *Market Wizards* not to be trading, there was a perfectly good reason for my inaction. One of the cardinal rules about trading is (or should be): Don't trade when you can't afford to lose. In fact, there are few more certain ways of guaranteeing that you *will* lose than by trading money you can't afford to lose. If your trading capital is too important, you will be doomed to a number of fatal errors. You will miss out on some of the best trading opportunities because these are often the most risky. You will jump out of perfectly good positions prematurely on the first sign of adverse price movement only to then see the market go in the anticipated direction. You will be too quick to take the first bit of profit because of concern

that the market will take it away from you. Ironically, over-concern about losing may even lead to staying with losing trades as fear triggers indecisiveness, much like a deer frozen in the glare of a car's headlights. In short, trading with "scared money" will lead to a host of negative emotions that will cloud decision making and virtually guarantee failure.

The completion of *Market Wizards* coincided with my having a house built. Perhaps somewhere out in this great country, there is someone who has actually built a house for what they thought it would cost. But I doubt it. When financing the building of a house, you find yourself repeatedly uttering that seemingly innocuous phrase, "Oh, it's only another $2,000." All those $2,000s add up, not to mention the much larger sums. One of our extravagances was an indoor swimming pool, and to help pay for this item I liquidated my commodity account—in the truest sense of the word. It was my sincerest intention not to resume trading until I felt I had adequate risk capital available, and an unending stream of improvements on the house kept pushing that date further into the future. In addition, working at a demanding full-time job and simultaneously writing a book is a draining experience. Trading requires energy, and I felt I needed time to recuperate without any additional strains. In short, I didn't want to trade.

This was the situation one day when, in reviewing my charts in the afternoon, I found myself with the firm conviction that the British pound was about to collapse. In the previous two weeks, the pound had moved straight down without even a hint of a technical rebound. After this sharp break, in the most recent week, the pound had settled into a narrow, sideways pattern. In my experience, this type of combined price action often leads to another price decline. Markets will often do whatever confounds the most traders. In this type of situation, many traders who have been long realize they have been wrong and are reconciled to liquidating a bad position—not right away, of course, but on the first rebound. Other traders who have been waiting to go short realize

that the train may have left without them. They, too, are waiting for any minor rebound as an opportunity to sell. The simple truth is that most traders cannot stand the thought of selling near a recent low, especially soon after a sharp break. Consequently, with everyone waiting to sell the first rally, the market never rallies.

In any case, one look at the chart and I felt convinced this was one of those situations in which the market would never lift its head. Although my strong conviction tempted me to implement a short position, I also felt it was an inappropriate time to resume trading. I looked at my watch. There were exactly ten minutes left to the close. I procrastinated. The market closed.

That night before leaving work, I felt I had made a mistake. If I was so sure the market was going down, I reasoned, I should have gone short, even if I didn't want to trade. So I walked over to the twenty-four-hour trading desk and placed an order to go short the British pound in the overnight market. The next morning I came in and the pound was down over 200 points on the opening. I placed a token amount of money into the account and entered a stop order to liquidate the trade if the market returned to my entry level. I rationalized that I was only trading with the market's money, and since my plan was to cease trading on a return to breakeven, I was not really violating my beliefs against trading with inadequate capital. Thus, I found myself trading once again, despite a desire not to do so.

This particular trade provides a good illustration of one of the principles that emerged from my interviews for *Market Wizards*. Patience was an element that a number of the supertraders stressed as being critical to success. James Rogers said it perhaps most colorfully, "I just wait until there is money lying in the corner, and all I have to do is go over there and pick it up. I do nothing in the meantime." In essence, by not wanting to trade, I had inadvertently transformed myself into a master of patience. By forcing myself to wait until there was a trade that ap-

peared so compelling that I could not stand the thought of not taking it, I had vastly improved the odds.

During the next few months, I continued to trade and my equity steadily increased, as I seemed to be making mostly correct trading decisions. My account grew from $0 (not counting an initial $4,000 deposit that was quickly withdrawn once profits more than covered margin requirements) to over $25,000. It was at this juncture, while traveling on a business trip, that nearly all my positions turned sour simultaneously. I made some hasty decisions between meetings, virtually all of which proved wrong. Within about a week, I had lost about one-third of my gains. Normally, when I surrender a meaningful percentage of my profits, I put on the brakes, either trading only minimally or ceasing to trade altogether. Instinctively, I seemed to be following the same script on this occasion, as my positions were reduced to minimal levels.

At this time, I received a call from my friend Harvey (not his real name). Harvey is a practitioner of Elliott Wave analysis (a complex theory that attempts to explain all market behavior as part of a grand structure of price waves).* Harvey often calls me for my market opinion and in the process can't resist telling me his. Although I have usually found it to be a mistake to listen to anyone else's opinions on specific trades, in my experience Harvey had made some very good calls. This time he caught my ear.

"Listen, Jack," he said, "you have to sell the British pound!" At the time, the British pound had gone virtually straight up for four months, moving to a one-and-a-half-year high.

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* The Elliott Wave Principle, as it is formally called, was originally developed by R. N. Elliott, an accountant turned market student. Elliott's definitive work on the subject was published in 1946, only two years befors his death, under the rather immodest title: *Nature's Law—The Secret of the Universe*. The application of the theory is unavoidably subjective, with numerous interpretations appearing in scores of volumes. (SOURCE: John J. Murphy, *Technical Analysis of the Futures Markets*, New York Institute of Finance, 1986.)

"Actually," I replied, "my own projection suggests that we may be only a few cents away from a major top, but I would never sell into a runaway market like this. I'm going to wait until there are some signs of the market topping."

"It will never happen," Harvey shot back. "This is the fifth of a fifth." (This is a reference to the wave structure of prices that will mean something to Elliotticians, as enthusiasts of this methodology are known. As for other readers, any attempt at an explanation is more likely to confuse than enlighten—take my word for it.) "This is the market's last gasp. It will probably just gap lower on Monday morning and never look back." (This conversation was taking place on a Friday afternoon with the pound near its highs for the week.) "I really feel sure about this one."

I paused, thinking: I've just taken a hit in the markets. Harvey is usually pretty good in his analysis, and this time he seems particularly confident about his call. Maybe I'll coattail him on just this one trade, and if he's right, it will be an easy way for me to get back on a winning track.

So I said (I still cringe at the recollection), "OK Harvey, I'll follow you on this trade. But I must tell you that from past experience I've found listening to other opinions disastrous. If I get in on your opinion, I'll have no basis for deciding when to get out of the trade. So understand that my plan is to follow you all the way. I'll get out when you get out, and you need to let me know when you change your opinion." Harvey readily agreed. I went short at the market about a half-hour before the close and then watched as prices continued to edge higher, with the pound closing near its high for the week.

The following Monday morning, the British pound opened 220 points higher. One of my trading rules is: Never hold a position that gaps sharply against you right after you have put it on. (A gap refers to

the market opening sharply higher or lower than the previous close.) The trade seemed wrong. My own instincts were to just get out. However, since I had entered this trade on Harvey's analysis, I thought it was important to remain consistent. So I called Harvey and said, "This short pound trade doesn't look so good to me, but since I don't think it's a good idea to mix analysis on a trade, my plan is to follow you on the exit of the position. So what do you think?"

"It's gone a little higher than I thought. But this is just a wave extension. I think we're very close to the top. I'm staying short."

The market continued to edge higher during the week. On Friday, the release of some negative economic news for the pound caused the currency to trade briefly lower during the morning, but by the afternoon prices were up for the day once again. This contrarian response to the news set off warning bells. Again, my instincts were to get out. But I didn't want to deviate from the game plan at this late juncture, so I called Harvey again. Well, as you might have guessed, the wave was still extending and he was still as bearish as ever. And yes, I stayed short.

On the next Monday morning, it was no great surprise that the market was up another few hundred points. A day later, with the market still edging higher, Harvey called. His confidence unshaken, he triumphantly announced, "Good news, I've redone my analysis and we're very close to the top." I groaned to myself. Somehow this enthusiasm over an event that had not yet occurred seemed ominous. My own confidence in the trade reached a new low.

No need to continue the gruesome details. About one week later, I decided to throw in the towel, Harvey or no Harvey. By the way, the market was still moving higher seven months later.

It is amazing how one trading sin led to a cascade of others. It started out with greed in wanting to find an easy way to recoup some losses—by following someone else's trade. This action also violated my

strong belief that it is unwise to be swayed by other people's opinions in trading. These errors were quickly followed by ignoring some screaming market clues to liquidate the position. Finally, by surrendering the decision process of the trade to another party, I had no method for risk control. Let me be absolutely clear that the point is not that I followed bad advice and lost money, but rather that the market is a stern enforcer that unmercifully and unfailingly extracts harsh fines for all (trading) transgressions. The fault for the losses was totally my own, not Harvey's (nor that of the method, Elliott Wave Analysis, which has been wed effectively by many traders).

I traded lightly for another month and then decided to call it quits as my account neared the breakeven point. It had been a quick ride up and down, with little to show for it except some market experience.

Several months later I was a speaker at a seminar at which Ed Seykota had agreed to make a rare appearance. Ed was one of the phenomenal futures traders I interviewed for *Market Wizards*. His views on the markets provide an unusual blend of scientific analysis, psychology, and humor.

Ed began his presentation by asking for a volunteer from the audience to point to the time periods on various charts that coincided with the dates of financial magazine covers he had brought along. He started in the early 1980s. The cover blared: "Are Interest Rates Going to 20%?" Sure enough, the date of the magazine cover was in near-perfect synchrony with the bottom of the bond market. At another point, he pulled out a cover with an ominous picture of farm fields withering away under a blazing sun. The publication date coincided with the price peak of the grain markets during the 1988 drought. Moving ahead to then-current times, he showed a magazine cover that read: "How High Can Oil Prices Go?" This story was written at the time of skyrocketing oil prices in the months following the Iraqi invasion of Kuwait. "My guess is that we've probably seen the top of the oil market," said Ed. He was right.

"Now you understand how to get all the important information about impending market trends from news and financial magazines. Just read the covers and forget about the articles inside." Quintessential Ed Seykota.

I was eager to speak to Ed so that I could relay my trading experiences and glean the benefits of his insights. Unfortunately, at every break during the seminar, each of us was surrounded by attendees asking questions. We were staying at the same small hotel in San Francisco. After we got back, I asked Ed if he cared to go out and find a spot where we could relax and talk. Although he appeared a bit beat, he agreed.

We walked around the area trying to find something that resembled a comfortable local bar or cafe, but all we managed to find were large hotels. Finally, in desperation, we wandered into one. In the lounge, a loud band and a truly bad singer were belting out their version of, what else— "New York, New York." (I'm sure if we were in New York, the band would have been playing "I Left My Heart in San Francisco.") This certainly would not do for a quiet conversation with the man I hoped would be my temporary mentor. We sat down in the lobby outside, but the strains of the music were still uncomfortably loud (yes, Virginia, there are sounds worse than Muzak), and the atmosphere was deadly. My hopes for an intimate conversation were quickly fading.

Trying to make the best of a bad situation, I related my recent trading experiences to Ed. I explained how I started trading again despite my reluctance to do so and the incredible string of errors I committed on the one British pound trade—errors that I thought I had vanquished years ago. I told him that, ironically, at one point before I put on the British pound trade, when I was still up about $20,000, I was in the market for a new car that cost exactly that amount. Since my house had virtually drained me of assets, I was tempted to cash in the account and use the proceeds to buy the car. It was a very appealing thought

since the car would have provided an immediate tangible reward for a few months of good trading without even having risked any of my own funds.

"So why didn't you close the account?" Ed asked.

"Well," I said, "how could I?" Although I managed to turn a few thousand dollars into $100,000 on a couple of occasions, I had always stalled out. I had never been able to really break through and extend it into some serious money. If I had decided to cash in my chips to make a purchase, I would always have wondered whether this would have been the time that I would have realized my trading goals. Of course, with the benefit of hindsight, I would have been much better off taking my profits, but at the time I couldn't see giving up the opportunity. I rationally explained all this to Ed.

"In other words, the only way you could stop trading was by losing. Is that right?" Ed didn't have to say anything more. I recalled that in my interview of him for *Market Wizards*, his most striking comment was: "Everybody gets what they want out of the market." I had wanted not to be trading, and sure enough that's what I got.

The moral here is: You don't always have to be in the market. Don't trade if you don't feel like it or if trading just doesn't feel right for whatever reason. To win at the markets you need confidence as well as the desire to trade. I believe the exceptional traders have these two traits most of the time; for the rest of us, they may come together only on an occasional basis. In my own case, I had started out with the confidence but without the desire to trade, and I ended up with neither. The next time I start trading, I plan to have both.