Stuart Walton

Back from the Abyss

In June 1999, at the peak of his career, after eight years establishing one of the most extraordinary stock trading track records of the 1990s, and with $150 million under management, Stuart Walton returned all money to his investors and walked away from trading completely. The emotional repercussions of a marital breakup were interfering with his ability to focus on trading, and he did not feel it was right to manage money until he could once again devote "100 percent energy and enthusiasm" to the task. In the preceding eight years, he had achieved an astounding 115 percent average annual compounded return in trading profits (92 percent for his clients after deducting management fees), with annual returns ranging from a high of 274 percent to a low of 63 percent (excluding the 1999 partial year).

Stuart Walton's career as a trader is marked by a string of contradictions and paradoxes. He wanted to be an artist or a writer; he became a trader. Though he valued academics and disdained the financial world, the markets became his profession. He once hated trading so much that he awoke feeling that he couldn't do it for another day and quit his job that morning; several years later, the markets were his endeavor and passion. His initial forays into stock trading were marked by such

ineptitude that he nearly went bankrupt, yet he subsequently became so skilled that he more than doubled his money annually.

I visited Walton, a Canadian expatriate, at his office in downtown San Francisco. I discovered that, although managing a nine-digit sum, he had no trading assistants, no back office staff, no marketing people, no programmers, not even a full-time secretary. His firm, Reindeer Capital, consisted of Stuart Walton alone. His isolation was deliberate. After having gone wrong so often by listening to tips and opinions, he had come to realize the importance of not being influenced by others while trading.

Walton was relaxed and outgoing. We talked for five hours straight without interruption. The time passed quickly.

Is there some significance to the name of the firm or are you just partial to reindeer?

The firm is named after my great-grandfather, William Gladstone Walton, who was given the nickname "Reindeer" for a famous trek he conceived and led. Much of what I know about him I learned from my grandfather, who passed away last year at the age of one hundred, narrowly missing the feat of having lived in three separate centuries. In 1892, at the age of twenty-three, Reindeer Walton left England to work as a missionary in northern Canada. He typically traveled over two thousand miles a year by canoe and dogsled, visiting his far-flung constituency—the Indians and Eskimos that lived around the Arctic Circle.

One year, vast forest fires swept through northern Quebec, destroying almost all the region's vegetation and game, and leaving the native population at the brink of starvation. Reindeer Walton came up with the idea of herding the Siberian reindeer, which are also

called caribou, from Alaska to northern Quebec. Through sheer perseverance, he convinced the Canadian government to finance the trek, which he organized and led. It took him five years, from 1921 to 1925, to herd three thousand reindeer across northern Canada. Reindeer are not like cattle; they move only when they want to move, and they go in all different directions.

How did he keep them herded together?

Caribou will follow the feeding path. He used a lot of foresight in choosing the right route. He succeeded in getting three-quarters of the herd to migrate; the remainder died or dispersed. His trek permanently changed the migration patterns for Siberian reindeer. The portion of the herd that survived flourished in northern Quebec, and he became a local hero.

Is there some principle you wish to symbolize by the name, or is it just a matter of honoring your great-grandfather?

I tell people that my great-grandfather added more value to society than I ever will.

When did you first get involved in the markets?

As soon as I graduated from McGill University with an M.B.A. I originally wanted to be a cartoonist.

A cartoonist with an M.B.A.? Were you planning to be the world's first business cartoonist?

No, the cartoonist ambitions came earlier. When I graduated from college, I definitely wanted to be a cartoonist. I sat down with the head of the art department, and he told me, "If you feel you know how to draw and represent the human body as well as one of the masters of art history and are then prepared to make five dollars per hour drawing cartoons, then this is definitely the career path

for you." His comments threw some cold water on my plans. I had also done some writing in college, and a few of my short stories had been published. I thought that journalism might be a good alternative career path that allowed some creativity.

Your interests seem to be so strongly artistic. Why did you go for an M.B.A.?

Because the journalism idea fell through as well, and I decided I needed to earn a living.

What went wrong with journalism?

I applied to several journalism schools. That summer, while visiting my parents, who were in Brazil at the time, I received a rejection call from Carleton University, which was my first choice for a journalism school. I received the call during a party. Maybe it was because I'd had too many Brazilian *caipirinhas,* which is their rum concoction, but I said to myself, "I guess this is another one of life's crossroads." So I decided to give up the idea of becoming a journalist. I guess I didn't want to do it badly enough to pursue it.

In retrospect, do you consider your rejection from journalism school a lucky event?

I consider it a huge stroke of luck. My father always told me that I had to differentiate between my hobbies and my career. I think he's right. My mother recently asked me if I had any regrets at not having pursued any of these other interests. At first I said that I didn't, because I was basking in the success I've had with this business, but every day that goes by, I regret it more and more. Eventually, I can see myself veering back.

Veering back to drawing or writing?

Maybe both, maybe neither. I always thought that the best way to

combine my interests in drawing and writing was films, particularly short films. I have a lot of ideas already. Nothing that would be commercial; stuff that probably would have an end audience of three people in the world.

Have you ever made any films?

No, I would have to take a film course just to learn how to point the camera.

Are you thinking of giving up trading in lieu of these other interests?

I really admire people who do what they want to do and don't care about anything else. I had a friend in college who was determined to be a rock and roll star. He formed the band The Cowboy Junkies. When he started college, he couldn't even play a guitar, and now he is sold out at every concert. But I know myself. I like the comforts of life, and for me this business is the best way to acquire them. Although, eventually, I will probably pursue some of these other interests, it's not something I see happening in the immediate future.

What happened after you were rejected from journalism school?

I decided to go for an M.B.A. because I thought it was the best way to get a job.

Did you give any thought to what you might do with your M.B.A.?

I intended to go into advertising because it was the one business career I thought might satisfy my creative side. But the opportunity never arose. When I graduated, the economy in Canada was terrible. There were only two jobs offered on campus. One was a management trainee position with Lloyds Bank. The job appealed to me because of the locations: New York or London. I thought it would be great to work in either of those two cities. I applied and

got the job. They sent me to a training program in New York. I spent most of the training program in the foreign exchange trading room, which was a fluke because I was supposed to be trained as a loan officer and sent back to Canada.

So you fell into a trading environment entirely by chance.

That is one reason why I believe anyone can do this job; I don't think you have to be born to do it.

I don't know about that. I can assure you that among the hundreds of thousands of people who try trading, very few can even remotely approach your track record. What was your job at the foreign exchange desk?

I was just a flunky. I took customer orders and did other assorted tasks. I had to be at work at 3:30 a.m.—which was brutal for a single guy living in New York—to get everything ready for the traders. I clipped newspaper articles for them and made sure their order tickets were in place. It was a glorified gofer position.

Did you have any interest in financial markets at the time?

None at all. I was still wrapped up in the idealism of my previous academic life. I looked down on my M.B.A. My thoughts were, "What happens to all the learning and academics I've done? Does it all just get shoved away for the rest of my life?"

The job in the foreign exchange department didn't help matters at all. If anything, it turned me off to trading because of all the day-to-day friction. The job was my first introduction to Americans; I had been surrounded by Canadians all my life. Canadians are more laid-back; they are more concerned about etiquette than going for the jugular or getting their point across. There were traders on the desk who would just scream at me all the time. Most times, I didn't

even know why. Maybe it was because they needed someone to take it out on when their positions went bad, or maybe it was because I didn't do things quickly enough for them. I would go home every night upset because someone had shouted at me.

How long did you stay at this job?

For about six months. I left because I found out through the grapevine that I was about to be transferred to Toronto. At that point, I loved living in New York, and I had also just met my wife-to-be and didn't want to leave her. Therefore, I took a job at the New York branch of another Canadian company, Wood Gundy. One attraction of the new job was that they offered to get me a green card; I had been in the United States on a temporary visa.

What was the job you got?

It was a little bit less of a flunky job. I went through Wood Gundy's training program and was placed on the equity desk. I was just an order taker, which was very boring. The customer was making the decision, and the floor broker was executing the trade; I was nothing more than an intermediary. I always laugh when brokers on the sell side of the stock business call themselves traders. Well they are not traders; they are just order takers. None of them are taking positions for the house or with their own money.

At that point, I made the first trade for my own account. My girlfriend, who later became my wife, worked for Liz Claiborne. She kept telling me how great her company was doing: "I don't even have to call my customers, they're calling me." Since I didn't have any money to invest, I called my father for a loan. "Dad," I said, "I have a great idea; you just have to lend me some money." He loaned me $10,000, and I put it all into Liz Claiborne stock. The stock quickly went up three points, and I took my profits. But the

worst thing you can do as a beginning trader is to have your first trade work. Within three weeks, I had lost not only all my profits from the Liz Claiborne trade, but also all the money my father had lent me.

How did you do that?

I was so taken with the success of my first trade that I started listening to all sorts of tips and rumors. The guy delivering my coffee in the morning could tell me about a stock, and I would buy it. I was cleaned out in three weeks. It took me five years, a little bit at a time, to pay back my father.

What did your father say when you told him you had lost the money?

"Well, I thought that you would," he said, "but I appreciated that you had an idea and wanted to follow through on it." Ironically, the Liz Claiborne stock, for which I had originally borrowed the money, continued to go straight up, quintupling in a year.

What was your next trading experience?

The Wood Gundy equity desk was another version of New York verbal abuse. Once again, I found myself at a job where the guys on the desk were constantly yelling at me. It was just regular day-to-day business, but I hated it. When I looked across the room to the bond trading desk, I noticed that everyone was very quiet. They weren't shouting at each other; they were very civil. That appealed to me. I got permission to switch to the bond trading desk.

At the time, Wood Gundy was trying to become a major dealer in the U.S. bond market, and they had brought in a bunch of hired-gun traders. These guys were just blowing up left, right, and center. There were huge losses everywhere. One trader even hid his tickets to conceal his losses. Eventually, almost everyone was fired, though I was still left, along with a few others.

Were you happier on the bond desk?

I had mixed feelings. I was certainly happy to get away from the verbal abuse. Also, the bond desk was very exciting because it traded huge position sizes compared with the equity desk. I liked the idea that I could make or lose five times as much as twenty people combined on the equity desk. But I didn't like being responsible for trading all sorts of illiquid issues, most of which were overseas bonds.

The Japanese would call me at 2 or 3 a.m., and I would have to make bids or offers on huge sums of illiquid bonds without even knowing where the market was. And because I was sleepy, it was possible to give them the wrong quote. If you gave them a quote that was off by 100 basis points, they would hold you to it. You could have a $1 million loss on an obvious error, and they would still insist on the trade being valid.

Did that ever happen to you?

Oh, yes.

You had a $1 million error?

Well, I didn't have a $1 million error, but I had a $300,000 error.

Just because you gave them the wrong quote.

I was sleepy. I thought the yield was 9.5 percent when it was really 10.5 percent.

Is it normal to be held on a trade on a quote that is obviously an error?

It certainly wouldn't be considered normal in North America, and I doubt that it would be the case anymore in Japan.

How did you do on balance in your trading?

I did well and was promoted as the youngest vice president at Wood Gundy.

On what basis were you making buy and sell decisions?

I didn't have any methodology. I almost got to the point where I thought the market was random.

But you must have been doing something right if you were making money. Was it just a matter of gut feel?

All the trading I do involves gut feel. But at that point in my life, I think I was bailed out because there was a major bull market in bonds, and my instincts were apparently good enough to keep me off the short side for the most part. In my best year, I made about $700,000 for the desk, which is really nothing, considering it has to be split among so many different people.

One time, over drinks with my boss, I said, "We're not really trading these bonds; we're really investing, just like one of our accounts. And if that is what we're doing, there are better things to invest in."

"Don't go off half-cocked," he said. "We just have to keep dodging and weaving."

It was at that point, after three years, that I really started to burn out. I went as long as I did because it was exciting having the responsibility of trading that much money.

By that point, had you developed a passion for trading?

Yes, I knew it was something I loved to do. I liked the idea that it was me against the markets. I just didn't care for the markets I was trading. One major source of frustration was that the bond issues we were trading in New York were highly illiquid. I decided to transfer to the main office of Wood Gundy in Toronto because

there I could trade Canadian government bond securities, which were far more liquid. At first I was very happy to be in the main office, trading liquid bond markets, with lots of activity. After six months, however, I realized that I didn't want to work in Canada. It's a country club environment where success has more to do with politics than with your performance. I was also getting very sick of bonds and interest rates.

Why?

Because it is such a commodity. At our morning meeting a standard question always was: "What is going to happen today?" All the participants would give this spiel about why they thought the market was going up or down. They would talk about the influence of currency rate movements, fiscal and monetary policy, interest rate trends in the United States and other countries, and so on. When my turn came, I would simply say, "I think the market is going down today." When they asked me why, I would answer, "Because it went up yesterday." They didn't know whether to take me seriously or not. I had reached the point where I thought the market was so efficient that if the price went up big one day, it was just as likely to go down the next day.

One morning I woke up and realized that I didn't want to worry about interest rates again for the rest my life. I knew that I couldn't stand to trade another bond. I walked into work and quit, even though I had moved to Canada only seven months earlier. They couldn't believe it.

You quit even though you didn't have another job?

Oh yeah, I just couldn't stand it anymore. The ironic thing is that my wife called me the same day to tell me that she had quit her job, and I hadn't even hinted to her that I was going to quit mine. I knew

she had been unhappy, but I didn't think she was on the verge of quitting. It was amazing that we both quit our jobs independently on the same day. We decided to delay looking for new jobs so that we could take six months to travel across the United States, going from ski resort to ski resort.

When we were at Lake Tahoe, we took a side trip to San Francisco. We loved the city and decided to move there. When we returned to Toronto after the end of our trip, we thought it would be a good idea to revisit San Francisco before actually moving, just to make sure that we still liked it as much as we had on our visit. While we were there, we looked for jobs, and we were both offered positions. We even found a house we liked and put in a bid that was accepted. We thought we were set. We flew back to Toronto, rented a truck, and moved our stuff to San Francisco. But when we got there, we found out that both jobs had fallen through.

What was the job you thought you had?

I had interviewed with a small venture capital firm. The person who interviewed me had also graduated from McGill.

You must have thought that gave you the inside track.

Yes, he was very enthusiastic. "Oh sure, we can use you. Come back out, and we will set you up." When I arrived in San Francisco, I kept calling him, but didn't receive any return phone calls. When I finally got through to him, he said, "Oh, we're not hiring M.B.A.s this year." It was a complete reversal from what he had told me before.

I had put my life savings into the down payment for the house, so we hardly had any money left. Initially, we weren't worried because we thought we would get jobs in a month or two. Month after month went by, however, and neither one of us got a job offer. I couldn't believe it. I started drinking cheap beer and sleeping late.

Were you depressed?

No, I'm not that kind of person. It was just too stressful for me to get up in the morning and pound the pavement. I couldn't believe that after having a successful career in New York, I couldn't even get a hint at a job offer. I was so desperate that I even went to insurance companies to interview for sales jobs.

Sounds as if that is a job you would have hated.

Absolutely, but I was desperate. I would have taken anything. I needed money to pay my mortgage, and I didn't want to ask my family for help.

What was your wife's attitude during this ordeal?

She was pretty positive. She felt we would come up with something.

Did you run out of money?

We did. Then after we had been there for six months, my wife got the first job, a retail sales position at J. Crew, which was a large step down for her after having been a merchandise manager for Liz Claiborne. She also had reached the point where she was willing to take virtually any job. We had just run out of money that month, and she used her first paycheck to pay the mortgage.

Were you panicking before she got her job at the last minute?

I had given up hope. My attitude was that whatever happens, happens. Take the house. I don't care. I was very distraught. That's when I first learned about San Francisco. They're not impressed if you're from New York, L.A., or London. It's not a transient city like New York or L.A., where it is okay to come from other cities and get a job. San Francisco is more of a community. People want to see that you have lived in the area for a while. Now I really appreciate that aspect of the city, but at the time it was very frustrating.

Do you mean the jobs you were applying for would go to people who were local?

Absolutely, although there wasn't a huge slew of jobs anyway. I couldn't believe that I had gone from a status position to the verge of working at Starbucks. I went to the library and microfiched every financial-sounding company and sent them my resumé. Eventually, I got a call from someone who liked my resumé. "I don't have a job for you myself," he said, "but I have a friend who I think might be interested."

What about your resumé appealed to him?

He liked the variety—a combination of financial jobs and artistic interests.

Before you got that job nibble, I imagine this must have been the low point of your life.

No, it wasn't. The low point is coming up. The person who had received my resumé convinced his friend who ran the sales and trading unit for Volpe, Welty & Co., a regional brokerage firm, to give me a shot at an interview. When I arrived at the interview, I had no idea what to expect. He asked me about my background, and I told him what I've just told you.

He then asked me, "How much do you want to make?" I added $200 to my mortgage and answered, "$2,500 a month." "How about $4,000?" he asked. "That would be good, too." I answered.

Did he know your predicament?

No, but he saw the jobs I'd held previously, and I don't think he felt right offering me as little as I was asking.

What job did he hire you for?

I was hired to be an institutional stockbroker, but I had no accounts. I had to cold-call in front of other people, which really got to me. I had gone from being Mr. Bond Trader, whom everybody wanted to take out to dinner, to cold-calling no-name institutions to buy our lousy stock ideas.

When you were cold-calling, I guess a lot of people just hung up on you.

Absolutely. I used to do waves of calls. I had a list of people to call, and I just put my head down and started dialing. I don't have an aggressive nature, so I tried drawing people in by just being a nice guy. That didn't work too well. It was a relentless day-after-day process. It was difficult watching other people doing business while I was making these phone calls, knowing that it was obvious to them whenever someone hung up on me. I would have a five-second conversation, put the phone down, and look around. Then I would have to go on to the next phone call. It was such a demeaning process. I hated it, hated it. I didn't know when I would ever be able to cover my draw. I couldn't generate a trade.

You don't mean that literally?

Yes, I do. I had zero trades.

How long did this go on?

I probably didn't have a single account or trade for eight months.

You cold-called for eight months without a single sale! That sounds brutal. Was this your low point?

No, this wasn't the low point *[he laughs].* The low point happened shortly afterward. Regardless of my lack of success in selling, I knew there was a big difference between trading and selling. Eventually,

after watching the markets, I decided I had to start trading again. Although I didn't have any money, I realized that I could take out a home-equity loan and do whatever I wanted with the money. I said to myself, "I can liquefy my house and invest it."

I can see it coming . . . .

I started selling stocks that I thought were up too high—powerhouse stocks like Liz Claiborne and the Gap—and buying stocks that I thought were down too low. In effect, I was shorting good companies and buying bad companies.

How much of a home-equity loan did you take out?

I had placed a down payment of $75,000 on the house, and I took out a loan of $50,000 against it. Within three weeks of taking out the loan, I had lost 75 percent of the money.

How did your wife react to this turn of events?

She had no idea.

She didn't know that you took out a home-equity loan?

She knew about the loan, but she didn't know what I did with the money.

What did you tell her you were going to do with the money?

I did tell her that I was going to invest it, but I told her that I was going to invest it in a conservative dividend play that would give us a greater return than the rate we had to pay on the home-equity loan. That was my intention. But once I had the money I thought, "I'm not going to put this into some boring dividend play to make a few dollars on the spread between the dividend income and my loan rate."

When you are at a brokerage firm, there is always something exciting going on. There is always some stock doubling or tripling. You can't avoid the frenzy. I was listening to the stories being pitched all around me. The salesmen could make any story sound great.

So apparently you had failed to learn your lesson about not listening to tips and rumors. You made the same mistake all over again.

Absolutely. I couldn't bring myself to tell my wife that I had lost almost all the money. I had trouble sleeping the entire month. I made up all these excuses why I was looking so sickly. I told my wife that I had the flu. She was worried, but she had no idea what the truth was. One day a buddy who worked beside me gave me a tip to buy Commodore Computer. "I think this story is really going to work," he said. "We're hearing that their latest game is going to be a high-flier." I was so desperate that I told myself, "I'm going to do it." I took everything that was left in my account, leveraged it at 200 percent, and bought the stock.

That was the low point in my life. The $75,000 I had put into my house was my entire savings. The thought that because of some gambling I could lose everything that I had built up in ten years of saving really scared me. It was the black abyss.

The stock went from $10 to $17, and I got out. After I liquidated, the stock reached as high as the low twenties, but it eventually went back down to zero when the company went bankrupt. That single trade was enough to almost make me whole again.

You actually were salvaged by pure luck, by a tip that could have been a disaster because the stock eventually ended up going to zero. You just happened to catch it during the right time window.

It was just luck. To this day, I look back at pivotal points in my life, and I don't know whether they were due to luck or intelligence, but

I never care about the difference. It's funny how things work out. I always tell people that luck is a very important factor in this business. Maybe you have to put yourself in the position to be lucky, but I think we all get our fair share of luck—both good and bad. We just have to take it as it comes.

That Commodore trade saved me. You might think my attitude would have been: "That tip worked, so I'm going to listen to other tips." But at the time, I recognized the luck involved. I realized that I was being bailed out by the stock market gods. I did learn my lesson. From that point on, I traded so much better.

Did you say, "Thank God, I won't sin again"?

Exactly. Even though everything worked out, the stress was incredible. Therefore, when I made it back, it was a godsend. Then I just started to chip away at it. Of course, I still had a lot to learn, but at least I had that experience behind me. I think it's important to get that low and see the abyss.

How did that help you?

The shock of the experience gave me clarity. I understood that stocks don't go up and stay up because of stories, tips, or people's opinions; they go up for specific reasons. I was determined to find those reasons, shut out the world, and then act on my own knowledge. I started to do that, and over time, my record got better and better.

This was really the first time in your life that you were trading stocks with any success. What types of things were working?

The theme I noticed back then that has persisted through bull and bear markets is: Good companies, on balance, continue to go up. Grandmothers in Kansas City know that.

And how do you find these good companies?

I look for companies that have been blessed by the market. They may be blessed because of a long string of quarters they've made [quarters in which the company's reported earnings reached or exceeded expectations], or for some other reason. You can identify these stocks by how they act. For some reason, the market goes to some stocks, and it doesn't go to others, no matter how many brokers tell their clients to buy these other stocks because they are cheap.

In effect, you actually reversed what you had been doing before: Instead of buying bargains and selling stocks that had gone up a lot, you were buying the expensive stocks.

That theme has continued to this day. The hardest thing to do is to buy a high-flying stock or to sell a stock that has gone down a lot, but I always find that the hardest thing to do is the right thing to do. It's a difficult lesson to learn; I'm still learning it now.

What tells you—to use your word—that a stock is "blessed"?

It's a combination of things. The fundamentals of the stock are only about 25 percent of it.

What is the remaining 75 percent?

Another 25 percent is technical.

What are you looking at on the technical side?

I like stocks that show relative linearity in their trend. I don't want stocks that are swinging all over the place.

That's 50 percent, and you have already gone through fundamental and technical. What's left?

Another 25 percent is watching how a stock responds to different

information: macroeconomic events, its own news flow. I also pay attention to how a stock reacts to going to round numbers: $20, $30, etcetera. I try to get a feel whether a company has that special shine to it.

What kind of response are you looking for?

I want to see a stock move higher on good news, such as a favorable earnings report or the announcement of a new product, and not give much ground on negative news. If the stock responds poorly to negative news then it hasn't been blessed.

That's 75 percent. What's left?

The last 25 percent is my gut feeling for the direction of the market as a whole, which is based on my sense of how the market is responding to macroeconomic news and other events. It's almost like looking at the entire market as if it were an individual stock.

How long do you typically hold a stock once you buy it?

I don't day trade, but I only hold a stock for an average of about a few weeks. Also, when I buy a stock, even if it's a core position of a few hundred thousand shares, I might be in and out of it twice in the same day and six times in the same week, trying to get a feel about whether I'm doing the right thing. If I'm not comfortable with the way the stock is trading, I get out. That's one thing I love about running a hedge fund. I don't have to worry about my customers seeing the schizophrenia in my trading. I used to work for a company where the customers received a confirmation statement for every trade that I did. They would go nuts. They would call up and say, "Are you crazy? What are you doing? I thought you were supposed to be doing real research."

What prompts you to get out of a stock?

I get out either because the stock looks as though it's rolling over, and I am in danger of losing what I have made, or because the stock has made too much money in too short a period of time.

Would you then look to buy back the stock on a correction?

Yes.

Does that work, or do you often end up missing the rest of the move?

I often end up missing the rest of the move because the stocks I am buying are good companies, and they usually continue to go up.

Have you considered changing your trading approach so that you hold stocks longer?

I have changed gradually over the years, but to this day, I still fall prey to the mistake of getting out too early.

When you get out of a stock, do you sometimes buy it back at a higher price?

Sure, all the time.

So you are at least able to bite the bullet and admit that you made a mistake by getting out, and then get back in at a higher price. You don't say, "I can't buy it now; I sold it $10 lower."

I may have done that in earlier years, but now buying back a stock at a higher price doesn't bother me at all. To me, the successful stock is not one that I bought at 10 and held to a 100, but one where I picked up 7 points here, 5 here, another 8 here, and caught a major part of the move.

But it sounds as if it would be easier to just buy one of these blessed stocks and hold it.

Sometimes, but it really depends on market conditions. For example, right now valuations are so high that I don't have any core positions that I intend to hold on to.

That brings me to a question I was going to ask: In this type of market, where the leading stocks have already seen such extraordinary price run-ups, do you still use the same approach? If not, how do you adjust your methodology?

To be honest, I'm having a hard time adjusting. My philosophy is to float like a jellyfish and let the market push me where it wants to go. I don't draw a line in the sand and say this is my strategy and I'm going to wait for the market to come to me. I try to figure out what strategies are working in the market. One year it might be momentum, another year it might be value.

So you adopt your strategy to match your perception of the market environment.

Exactly, I try to anticipate what the market is going to pay for.

How do you know when there is a sea change?

I'll look at everything and listen to as many people as I can, from cab-drivers to stock analysts. Then I sit back and try to see what idea rises to the top. Sometimes the opportunities are so obvious that you almost can't lose when they come around; the only problem is that they don't come around that often. The key is not to lose money in the times in between.

Give me an example of an opportunity that was that obvious.

Last year [1998] it was very clear to me—I don't like saying stuff like this because it makes it sound as though I have a crystal ball—that

the market had a very good chance of rolling over in a serious way during August.

What made you so sure?

I constantly evaluate market sentiment—Is the market hopeful? Is it fearful?—and wait for the price action to confirm my assessment. Throughout last winter and spring, the situation was very confounding. There were lots of reports about potential problems in Asia, but the market ignored everything. Therefore, the only way to make money was to be long, even in the face of this potential trouble.

So I decided to get really long in July. The leaders were performing great, and the market was roaring. At one point, I was up 15 percent for the month. Then all of a sudden, in a matter of days, I lost everything and actually found myself down 3 percent for the month. The market took the money away so quickly that just by looking at my own portfolio, which was filled with market leaders, not stocks with poor fundamentals, I knew something had to be wrong.

What did you do at the time? You said you had started out the month heavily long. Did you cover your entire position? Did you go net short?

I was 130 percent long. What I typically do when I believe there's a major bearish event occurring in the market is to sell everything and then just watch. That's what **I** did then.

Did you go short?

Yes, about two weeks later. I thought that the Asian crisis that precipitated the break would have a second leg to it. Usually you don't just hear about a problem and then have it end. We also started seeing headlines about potential problems in Russia. Although we had seen these types of news reports before, the difference this time around was that prices were responding. I felt convinced that the

situation would continue. Russia was not going to get fixed the next day, neither would Thailand or Korea, and prices were reflecting these fears. During the second week of August, I went 130 percent net short, and the scenario played out. To me it was very obvious.

When did you cover your short position?

I covered my shorts during the second week of October. I have a number of rules taped to my quote machine. One of these is: Buy on extreme weakness and sell on extreme strength. The only way to identify extremes is to get a feel for the sentiment, whether it is euphoria or pessimism. Then you have to act on it quickly, because there are often abrupt peaks and bottoms. By the second week of October, I felt that I had to take advantage of the opportunity of the market's extreme weakness to cover all my shorts. I covered the entire position in one day and actually went net long 25 percent.

Was there anything significant about that day in particular that prompted you to reverse your position?

That day, stocks like Dell went down from 50 to 40, and before the end of the day they were going up 2 or 3 points at a clip.

So you were buying these stocks at much higher prices than they were trading at earlier the same morning.

Absolutely. Actually one of the things I like to see when I'm trying to buy stocks is that they become very difficult to buy. I put an order in to buy Dell at 42, and I got a fill back at 45. I love that.

Do you just put your buy orders in at the market, or do you try to get filled at a particular price?

I always buy and sell at the market. I never mess around trying to get the best fill. I'm a broker's dream.

You said you went long about 25 percent. When did you increase that long position?

Whenever I start to go back in on the long side, I like to wait and see that the market rebound continues the next day and that there is no further bearish news. If there is additional bearish news and the market doesn't go down, then I really go nuts.

Did that happen then?

It didn't happen the next day, but it happened later in the week. There was more news about the collapse of Long Term Capital. [The multibillion-dollar hedge fund was overleveraged in the bond market and suffered enormous losses, leading to fears of repercussions to the entire financial system. See David Shaw interview.] The market just shrugged it off. That gave me greater confidence to just plow in on the long side. I had a chance to buy all these market leaders while they were down sharply from their peaks, which I love to do.

Did the all-or-nothing trade that recouped most of the money you had lost from your home-equity loan mark the beginning of your successful trading career? Did you stay true to your vow to give up your trading transgressions?

For the most part. I immediately started trafficking in quality growth names. I bought the stocks that went up more than the market when the market was going up. 1 figured those were the horses to bet on. I forced myself to buy these stocks on down days. I found these stocks would often go up five points in a week, whereas I would have been lucky to get five points in a year in the low-quality stocks I had previously been buying.

The only time I really got into trouble was when I fell prey to a great sales pitch. The most dangerous thing on the Street is the

ability to communicate. I worked with some great salesmen. They would say, "Stuart, you have to look at this." And sometimes in a weak moment, I would rationalize that I'd done well and had some extra money to speculate with. Maybe this trade would work, and if it didn't, I'd get out quickly. Before I knew it, I would be down 20 or 30 percent on the trade. It's a lesson that I continually have to learn.

Do you still find yourself vulnerable to listening to tips even now?

Absolutely. At some level, I have a gambling urge, which I decided a long time ago I needed to satisfy, but in a small way. Therefore, I set aside a small amount of money in the fund for doing these speculative trades.

On balance, do you end up winning or losing on these trades?

About breakeven.

How did you go from being a stockbroker to a fund manager? For that matter, did you ever make a sale?

Eventually I started to do okay as a stockbroker because I learned how to sell.

How do you sell?

You need to find out what the customer wants and package your sales pitch—not the product—accordingly.

What did the customer want?

Instant gratification, excitement, sizzle, the comfort of knowing that lots of other people were buying the same stock, and a million reasons why the stock would go up.

So you tried to make the stock sound as good as possible without any qualifications?

Absolutely. That's what all stockbrokers do.

Weren't you troubled by making something uncertain sound certain?

Sure, but it wasn't exactly lying, because I had no idea whether the stock would go up or not. It was, however, a huge embellishment. After a while, I just couldn't hack it anymore.

How did you get out of it?

After I started doing well in my own account, I began recommending some of my own ideas, not just the stocks that were part of the company line. I was bailed out by one of my accounts who liked my style and offered me a job to manage money for them. That was really what I wanted to do. If I hadn't landed that job, I would have had to quit because I was once again at the point of waking up in the morning and feeling I can't do this anymore.

What kind of firm was it?

It was a registered investment advisory firm that managed about $300 million in institutional accounts. They had their own strategy on how to invest.

Were you allowed to make your own trading decisions, or did you have to follow their guidelines?

I could buy any stock I wanted, but it had to meet their investment criteria.

What were those restrictions?

The price/earnings ratio had to be below 15. Earnings had to be growing by at least 20 percent per year. There were also some balance sheet and liquidity conditions that had to be met.

Was that a help or a hindrance?

It was a huge impediment because it dramatically narrowed the universe of companies that I could invest in.

What stocks were you missing because of this policy?

For example, I couldn't buy a Microsoft or a Cisco; instead I had to buy a Novell or a 3Com.

Because the price/earnings ratio was greater than fifteen?

Right.

Do you feel it is a flawed investment policy to try to buy stocks that have low price/earnings ratios?

Not necessarily. I would never adopt that type of strategy myself, but I feel that any sound strategy will work as long as you stick to it.

Were there any restrictions on the stocks you bought for your own account?

I was allowed to buy any stocks I wanted to, as long as they were not the same names I was buying for the company's clients.

What was the difference in performance between your own account and the accounts you were managing for the company?

For the company accounts, I would only be up an average of 15 to 20 percent per year, while on my own account, I was averaging well over 100 percent per year.

Did you try going to management and saying, "Look, here's what I've been doing for my own account without any restrictions. Let me trade the company accounts the same way."

Sure, but they had geared the firm to follow their particular philosophy, and that's what the customers bought into. The last thing

an investor wants to see is a change in strategy. My idea, however, was to try to adapt to any new strategies that seemed to be working. Eventually I built up enough capital in my own account so that I could go my own way. I started a fund with $1.3 million, about half of which was my own.

How did you get investors?

Strictly word of mouth. I didn't do any marketing.

I see that you're here completely on your own, which is amazing for a hedge fund managing $150 million. Don't you have any help?

I have a secretary who comes in every other day.

That's it? Don't you need any additional assistance?

I hired someone last year—a great guy who is now off on his own—but I knew immediately that it wasn't for me.

Why is that?

I found that having another opinion in the office was very destabilizing. My problem is that I am very impressionable. If I have someone working for me every day, he may as well be running the money because I'm no longer making my own decisions.

I like quiet. I talk all day on the phone, and that's enough for me. I don't need committees, group meetings, and hand-holding to rationalize why a stock is going down. I even like the fact that my assistant only comes in every other day, so that every alternate day I am completely on my own and can sit here and germinate.

I understand that completely, because I work in a home office. I find that when you work on your own, you can get completely engrossed in what you are doing.

Exactly. That's the main reason I like to be on my own. People come

in here and ask me, "How could you manage this much money on your own? Don't you want to become a bigger firm?"

What do you tell them?

Well, it's worked for me so far. The only thing that matters is how well I do, not the amount of zeros I'm managing.

With your track record, you could easily raise a lot more money.

That would just kill everything. The only way I can possibly maintain my track record is to make sure I don't overwhelm myself with assets. Right now, if I have a good quarter, it ramps up the amount of money I am managing. By growing through capital appreciation, I can evolve my trading style to accommodate the increase in assets managed.

I guess you would rather make 50 percent plus on a $150 million than 20 percent on $1 billion.

Exactly. A lot of people who do well and decide to dramatically increase their assets find that their first year is their best year. After that, it's downhill. Of course, they still make huge sums of money. But I want to feel good about coming in every day. I want to have happy customers and see my assets steadily growing. I don't want to be cranking out a great living on a business that is deteriorating. I have almost no overhead, so I still make a great income. There is no need to get greedy.

Do you think the experience of coming close to the edge of bankruptcy helped you become successful?

Definitely.

In what way?

The odd thing about this industry is that no matter how successful

you become, if you let your ego get involved, then one bad phone call can put you out of business. My having seen the abyss might spare me from making that phone call. I know how quickly things can go bad. Any stock can go to zero, and you need to realize that.

When I talk to potential new investors I focus on my mistakes. Because if you are going to invest with someone, you want that person to have made mistakes on his own tab and not to make them on yours. Someone who has never made a mistake is dangerous, because mistakes will happen. If you've made mistakes, you realize they can recur, and it makes you more careful.

We've talked about the mistakes you've made early in your career. What mistakes have you made during your more recent successful years?

This year I got very bearish without waiting for prices to confirm my opinion.

What made you so blindly bearish?

I became very concerned about the rise in interest rates. In the past, higher interest rates had always led to lower stock prices, and I assumed the same pattern would repeat this year. The market, however, chose to look at other factors. I didn't wait for the market to confirm the fear of higher interest rates, and I lost money very quickly. I was down 7 percent in March, which is a pretty big one-month drop for me.

Any other mistakes come to mind?

In January 1998, I invested in a bunch of small-cap initial public offerings (IPOs), which all performed incredibly poorly in the first quarter they went public.

What was your mistake there?

My mistake was getting involved in illiquid securities without doing sufficient research.

What prompted you to buy these stocks?

Market sentiment. The market was getting very excited about conceptual IPOs—stocks with a dream and a story but no earnings. When stocks like these go sour, they can go down 70 percent or more very quickly. It was as if a tornado had swept through my portfolio. I was down 12 percent for the month and decided to liquidate everything. One stock that I bought at 18, I sold at 2.

If these stocks were down that much, wouldn't you have been better off holding them in case they bounced back? What happened to these stocks after you liquidated them?

They bounced, but not by much. As I liquidated these stocks, I used the money to buy the types of stocks that I should've been buying—good companies at much higher prices.

So you had deviated from your philosophy.

Yes, once again. It's like a junkie who is off drugs for three years and then runs into some crack dealer who is able to convince him to start again. I don't mean to blame other people for convincing me. It was my own fault for allowing myself to be susceptible to these stories. I think I've learned not to trade on those types of stories anymore. The good news is that I quickly switched back to buying the types of companies that I like. By the end of the quarter, I had recovered all my losses.

I guess the implication is that holding on to a losing stock can be a mistake, *even if it bounces back,* if the money could have been utilized more effectively elsewhere.

Absolutely. By cleaning out my portfolio and reinvesting in solid stocks, I made back much more money than I would have if I had kept the other stocks and waited for a dead cat bounce.

Do you talk to companies at all?

I used to visit companies all the time when I was working for the investment advisory firm.

Did it help at all?

Hardly at all. I found that either they told me what they had previously told everyone else, and it was already factored into the price, or else they lied to me. Once in a blue moon you would learn something valuable, but there was a huge opportunity cost traveling from company to company to get that one piece of useful information.

Can you give me an example of a situation where management lied to you?

The examples are almost too numerous to remember.

Pick out one that stands out as being particularly egregious.

I saw Autumn Software* make a presentation at a conference. I had never heard such a great story. They produced software that was used in computer backup systems all around the world. The management team was very believable and articulate. The stock was high, but I felt it was a big momentum horse. I bought half a million shares, and the stock started to crumble almost immediately.

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* Pseudonym.

I called management and asked them what was happening. "We have no idea," they said. "Business is actually better than last month." One day I was out at Nantucket, and I received a phone call informing me that Autumn had just preannounced that they would have a disappointing quarter. The stock, which had closed at 30 that day, opened at 7 the next morning. It was funny because every time I had talked to the company, "business had never been better." That proved to me that as an outside investor you never know the truth.

Is this an example of a situation in which you ignored your own rule of paying careful attention to how a stock responds to news, or if it goes down for no apparent reason?

Unfortunately for my former employer, I was still learning that lesson at the time.

Did that experience sour you completely on talking to management?

Not completely. I might call a company's management when its stock is very low and no one is talking to them, because that is when they are usually desperate enough to talk to anyone. My hope is that I might learn about some catalyst that could cause the stock to turn around.

What are the traits of a successful trader?

I think a lot of successful traders are unemotional, hardworking, and disciplined. Ironically, I find myself lacking on each of those counts. I get very emotional; I really don't work that hard; and I'm not as disciplined as I should be. I would attribute my own success to having both conviction about my gut feelings and the ability to act on them quickly. That is so critical.

So in your own case, you've been able to offset some other drawbacks simply by having the ability to pull the trigger?

Exactly, that's a very good point.

What is the biggest misconception people have about the stock market?

Currently, the biggest misconception is the widespread belief that it is easy to make a living trading in the stock market. People feel they can give up their jobs and trade for a living; most of them are bound to be disappointed.

What are the trading rules you have posted on your computer?

- Be patient—wait for the opportunity.
- Trade on your own ideas and style.
- Never trade impulsively, especially on other people's advice.
- Don't risk too much on one event or company.
- Stay focused, especially when the markets are moving.
- Anticipate, don't react.
- Listen to the market, not outside opinions.
- Think trades through, including profit/loss exit points, before you put them on.
- If you are unsure about a position, just get out.
- Force yourself to trade against the consensus.
- Trade pattern recognition.
- Look past tomorrow; develop a six-month and one-year outlook.
- Prices move before fundamentals.
- It is a warning flag if the market is not responding to data correctly.

- Be totally flexible; be able to admit when you are wrong.
- You will be wrong often; recognize winners and losers fast.
- Start each day from last night's close, not your original cost.
- Adding to losers is easy but usually wrong.
- Force yourself to buy on extreme weakness and sell on extreme strength.
- Get rid of all distractions.
- Remain confident—the opportunities never stop.

I know you have no desire to be working with anyone, but let's say five years from now you decided to pursue a new career making films. Could you train someone to take over for you and invest in accordance with your guidelines?

I could teach someone the basic rules, but I couldn't teach another person how to replicate what I do, because so much of that is based on experience and gut feeling, which is different for each person.

After you reach a certain level of financial success, what is the motivation to keep on going?

The challenge of performance and the tremendous satisfaction I get from knowing that I contributed to people's financial security. It's fantastic. I have a lot of clients, some of whom are my own age, who I have been able to lead to total financial independence.

How do you handle a losing streak?

I trade smaller. By doing that, I know I'm not going to make a lot, but I also know I'm not going to lose a lot. It's like a pit stop. I need to refresh myself. Then when the next big opportunity comes around—and it always does—if I catch it right, it won't make any difference if I've missed some trades in the interim.

What advice do you have for novices?

Either go at it full force or don't go at it at all. Don't dabble.

Is there anything pertinent that we haven't talked about?

It is very important to me to treat people with fairness and civility. Maybe it's a reaction to all the abuse I took in the New York trading rooms. But, whatever the reason, the everyday effort to treat others with decency has come back to me in many positive ways.

Stuart Walton had no burning desire to be a trader, no special analytical or mathematical skills, and was prone to emotional trading decisions that caused him to lose all or nearly all his money on several occasions. Why, then, did he succeed, let alone succeed so spectacularly?

There are five key elements:

1. *Persistence.* He did not let multiple failures stop him.

2. *Self-awareness.* He realized his weakness, which was listening to other people's opinions, and took steps to counteract this personal flaw. To this end, he decided to work entirely alone and to set aside a small amount of capital—too small to do any damage—to vent his tip-following, gambling urges.

3. *Methodology.* Walton became successful exactly when he developed a specific market philosophy and methodology.

4. *Flexibility.* Although Walton started out by selling powerhouse stocks and buying bargains, he was flexible enough to completely reverse his initial strategy based on his empirical observations of what actually worked in the market. If he believes a stock he previously owned is going higher, he is able to buy it back at a higher price without hesi-

tation. If he realizes he has made a mistake, he has no reservation about liquidating a stock, even if it has already fallen far below his purchase price. Finally, he adjusts his strategy to fit his perception of the prevailing market environment. In Walton's words, "One year it might be momentum, another year it might be value."

5. *Diagnostic capability.* Most great traders have some special skill or ability. Walton's talent lies in not only observing the same news and information as everyone else, but also in having a clearer insight into the broad market's probable direction—sometimes to the point where the market's future trend appears obvious to him. This market diagnostic capability is probably innate rather than learned. As an analogy, two equally intelligent people can go to the same medical school, work equally hard, and intern in the same hospital, yet one will have much greater diagnostic skill because ability also depends on intrinsic talent.

Walton's case history demonstrates that early failure does not preclude later success. It also exemplifies the critical importance of developing your own methodology and shutting out all other opinions.

Update on Stuart Walton

Walton left trading in the midst of a roaring bull market after eight years in which he achieved a remarkable triple-digit average annual return (gross). He returned to trading in the midst of a bear market (January 2001), out of step with the changed environment. In the 21 months since his return, he experienced an index-like cumulative decline, losing 6 percent more than the S&P 500 and 4 percent less than the NASDAQ. In this follow-up interview, we discussed the

reasons for Walton's drastic performance reversal and the changes he has made in his trading approach as a result.

You had an eight-year run with exceptional returns, then took a sabbatical, and experienced a terrible year on your return. What happened?

When I stopped trading in mid-1999, the NASDAQ had not yet reached its frenzied overdrive phase. It had been going up over 20 percent per year, but in the mere eight months after I quit, it shot up another 75 percent. So I didn't trade through that period of explosive price gains and market euphoria. Similarly, I didn't trade through the subsequent bursting of that bubble. When I returned in 2001, since I hadn't lived through the excesses the market had gone through, I didn't fully appreciate the extent of the emotional damage the market had sustained in 2000. My most recent trading experience had been the success I had witnessed in the 1990s by zigging and zagging to the rhythm of the markets. As a result, instead of playing for the big trade, which was the continuation of the downmove, I was still trying to play the market from both sides. With the benefit of hindsight, it is clear that I suffered from a lack of perspective.

Many of the indicators that have worked reliably for decades have ceased working in the current bear market, leaving many professional market participants looking foolish. The problem is that most of us have not seen a comparable stock market in our lifetimes. Very few of us have lived through the aftermath of the bursting of a market bubble. The closest analogy would the 1930s in the United States or the 1990s in Japan.

Do you mean to suggest that the current bear market could be as protracted as those extreme examples?

The analogy is not totally appropriate insofar as the current U.S. economy is far sounder than the U.S. economy of the 1930s or the Japanese economy during the past ten to fifteen years. But one reason to think this way is that I don't believe the current stock market malaise will come to a permanent end until memories of the 1990s bull market are completely erased. There are still too many people ready to try to pick bottoms and buy tech stocks.

If you just look at some of these tech companies on the basis of their fundamentals—negative earnings, huge debt, high valuations—there would no conceivable reason to go near them. Yet many people are still jumping in any time these stocks begin to rebound. Why? Because they still have the memory of how these stocks went from $10 to $200 in the late 1990s. It is reminiscent of the typewriter companies with the advent of the computer. Investors had been so taken, for so long, with the dominance of the typewriter, that even as it became clear that the PC revolution had started, people were still willing to buy Smith Corona all the way down to zero. The same kind of general dynamic seems to have taken hold in the technology and speculative portions of the current market.

As another example, you couldn't get a more frightening, destabilizing event than what occurred on September 11. Yet the market failed to remotely approach the extreme levels it had seen many times in the past, particularly in times of crisis. I found that amazing; it made me realize that it would take a long time for this process to unwind itself. Every time one of these rallies fails and the market falls to new lows, as was the case with the recent breaking of the September 2001 lows, it disenchants more and more people. But the absence of extremes suggests this process still has to be repeated before the bear market comes to an end.

By extremes, do you mean extreme low valuations?

Yes, certainly valuation levels in September 2001, and even the lower lows in July 2002, were well above levels seen at past market bottoms, but I am also talking about measures of extreme emotion, such as downside volume versus upside volume. In this context, the levels seen in the aftermath of September 11 and the July 2002 lows were nowhere near other past extremes, which is one of the main reasons why I believe we are going to see more unwinding of the excesses of the 1990s. Nevertheless, if the market is going to have a strong three-month rally, I want to participate in that rebound regardless of my long-term viewpoint.

How do you distinguish between a market that is beginning an intermediate rally and one that is just witnessing a one-week pop?

From a technical perspective, I would look for lots of trendlines being broken and stocks moving up on volume. Also I approach the market one stock at a time, one day at a time. I don't just say now is a good time to play for a three-month upmove and load up on long positions. If a stock's fundamentals look sound, the stock and sector are acting well technically, and the general market tone is improving, I may put on a position and stay with it as long as these factors don't deteriorate significantly.

Do you always use stops?

Yes.

Why didn't that help in 2001?

I was using stops, but I had one horrendous month—February—in which my entire portfolio got stopped out twice. Leading companies had gone down 50 to 70 percent, so I bought a basket of these stocks, which then promptly proceeded to go down another 10 percent, stopping me out. I tried the same set of trades later in the

month, and was stopped out again. I now use risk controls at the portfolio level in addition to stops on individual stocks. If the portfolio is down 5 percent in any month, I will pare down the exposure, and if it declines by 10 percent, I will go completely to cash.

Besides the failure to focus sufficiently on risk at the portfolio level, what has been the worst mistake you have made since your return to trading?

Not appreciating how drastically a bear market can change the balance between return and risk. For example, say you like a pharmaceutical company because you have done thorough research that leads you to believe there is an 80 percent probability that the FDA will approve their drug application. In the current bear market environment, even if you are right about the odds, the trade may be a bad bet because the stock might go up only 5 percent with a favorable ruling, but go down 50 percent with an unfavorable ruling.

What is the most important lesson you have learned from your difficult experience in 2001?

The importance of only trading with an edge—not to trade when there is no trade.

Are you trading less now?

Yes, radically less. I've re-examined my trading at my prior hedge funds and found that during those periods in which my turnover was the highest, I never made any real progress. When I look back at those times, I realize they were the same periods when my emotions were running at their highest. Too much emotion tends to lead to too much turnover and bad decisions. Although I still like to be spontaneous, I now put myself through more mental drills before I decide to put on a trade.