WIZARD LESSONS

1. There Is No Single True Path

There is no single true path for succeeding in the markets. The methods employed by great traders are extraordinarily diverse. Some are pure fundamentalists; others use only technical analysis; and still others combine the two methodologies. Some traders consider two days to be long term, while others consider two months to be short-term. Some are highly quantitative, while others rely primarily on qualitative market decisions.

2. The Universal Trait

Although the traders interviewed differed dramatically in terms of their methods, backgrounds, and personalities, there were numerous traits common to many of them. One trait that was shared by all the traders is discipline.

Successful trading is essentially a two-stage process:

- Develop an effective trading strategy and an accompanying trading plan that addresses all contingencies.
- Follow the plan without exception. (By definition, any valid reason for an exception—for example, correcting an oversight—would become part of the plan.) No matter how sound the trading strategy, its success will depend on this execution phase, which requires absolute discipline.

3. You Have to Trade Your Personality

Cohen emphasizes that it is critical to adopt a trading style that matches your personality. There is no single right way to trade the markets; you have to know who you are. For example, don't try to be both an investor and a day trader. Choose an approach that is comfortable for you. Minervini offers similar advice: "Concentrate on mastering one style that suits your personality, which is a lifetime process."

Successful traders invariably gravitate to an approach that fits their personality. For example, Cook is happy to take a small profit on a trade but hates to take even a small loss. Given this predisposition, the methodologies he has developed, which accept a low return/risk ratio on each trade in exchange for a high probability of winning, are right for him. These same methods, however, could be a mismatch for others. Trading is not a one-size-fits-all proposition; each trader must tailor an individual approach.

4. Failure and Perseverance

Although some of the traders in this book were successful from the start, the early market experiences of others were marked by complete failure. Mark Cook not only lost his entire trading stake several times, but on one of these occasions he also ended up several hundred thousand dollars in debt and a hair away from personal bankruptcy. Stuart Walton wiped out once with money borrowed from his father and several years later came close to losing not only all his trading capital, but also the money he borrowed on a home equity loan. Mark Minervini lost not only all his own money in the markets, but some borrowed money as well.

Despite their horrendous beginnings, these traders ultimately went on to spectacular success. How were they able to achieve such a complete metamorphosis? Of course, part of the answer is that they had the inner strength not to be defeated by defeat. But tenacity without flexibility is no virtue. Had they continued to do what they had been doing before, they would have experienced the same results. The key is that they completely changed what they were doing.

5. Great Traders Are Marked by Their Flexibility

Even great traders sometimes have completely wrongheaded ideas when they start. They ultimately succeed, however, because they have the flexibility to change their approach. Benjamin Franklin said, "One of the greatest tragedies of life is the murder of a beautiful theory by a gang of brutal facts." Great traders are able to face such "tragedies" and choose reality over their preconceptions.

Walton, for example, started out by selling powerhouse stocks and buying bargain stocks. When his empirical observations of what actually worked in the market contradicted this original inclination, he was flexible enough to completely reverse his approach. As another example, when Minervini was a novice trader he favored buying low-priced stocks that were making new lows, an approach that was almost precisely the opposite of the methodology he ended up using.

Markets are dynamic. Approaches that work in one period may cease to work in another. Success in the markets requires the ability to adapt to changing conditions and altered realities. Some examples:

- Walton adjusts his strategy to fit his perception of the prevailing market environment. As a result, he might be a buyer of momentum stocks in one year and a buyer of value stocks in another. "My philosophy" he says, "is to float like a jellyfish, and let the market push me where it wants to go."
- Even though Lescarbeau has developed systems whose performance almost defy belief, he

continues his research to develop their replacements so that he is prepared when market conditions change.

- Fletcher's primary current strategy evolved in several stages from a much simpler earlier strategy. As competitors increase in the current approaches he is utilizing, Fletcher is busy developing new strategies.
- Cohen says, "I'm always learning, which keeps it exciting and new. I'm not doing the same thing that I was doing ten years ago. I have evolved, and will continue to evolve."

6. It Requires Time to Become a Successful Trader

Experience is a minimum requirement for success in trading, just as it is in any other profession, and experience can be acquired only in real time. As Cook says, "You can't expect to become a doctor or an attorney overnight, and trading is no different."

7. Keep a Record of Your Market Observations

Although the process of gaining experience can't be rushed, it can be made much more efficient by writing down market observations instead of depending on memory. Keeping a daily diary in which he recorded the recurrent patterns he noticed in the market was instrumental to Cook's transition from failure to great success. All of the many trading strategies he uses grew out of these notes. Masters jots down observations on the backs of his business cards. A compilation of these notes provided the basis for his trading model.

8. Develop a Trading Philosophy

Develop a specific trading philosophy—an integration of market concepts and trading methods—that is based on your market experience and is consistent with your personality (item 3). Developing a trading philosophy is a dynamic process—as you gather more experience and' knowledge, the existing philosophy should be revised accordingly.

9. What Is Your Edge?

Unless you can answer this question clearly and decisively, you are not ready to trade. Every trader in this book has a specific edge. Here are a few examples:

- Masters has developed a catalyst-based model that identifies high probability trades.
- Lauer employs a specific six-step selection process that identifies stocks with extremely favorable return/risk prospects.
- Cook has identified price patterns that correctly predict the short-term direction of the market approximately 85 percent of the time.
- Cohen combines the information flow provided by the select group of traders and analysts he has assembled with his innate timing skills as a trader.
- A tremendous investment in research and very low transactions costs have made it possible for Shaw's firm to identify and profit from small market inefficiencies.
- By combining carefully structured financing deals with hedging techniques, Fletcher and Guazzoni implement transactions that have a very high probability of being profitable in virtually any scenario.
- Watson's extensive communication-based research allows him to identify overlooked stocks that are likely to advance sharply well before those opportunities become well recognized on Wall Street.

10. The Confidence Chicken-and-Egg Question

One of the most strikingly evident traits among all the Market Wizards is their high level of confidence. This leads to the question: Are they confident because they have done so well, or is their success a consequence of their confidence? Of course, it would hardly be surprising that anyone who has done as extraordinarily well as the traders in this book would be confident. But the more interviews I do with Market Wizard types, the more convinced I become that confidence is an inherent trait shared by these traders, and is as much a contributing factor to their success as a consequence of it. To cite only a few of the many possible examples:

- When Watson was asked what gave him the confidence to pursue a career in money management when he had no prior success picking stocks, he replied, "Once I decide I am going to do something, I become determined to succeed, regardless of the obstacles. If I didn't have that attitude, I never would have made it.'
- Masters, who launched his fund when he was an unemployed stockbroker with virtually no track record, gave this response to a similar question. "I realized that if somebody could make money trading, so could I. Also, the fact that I had competed successfully at the highest levels of swimming gave me confidence that I could excel in this business as well."
- Lauer was almost apologetic about his confidence when he decided to switch careers from analyst

to money manager: "I hesitate to say this because I don't, want to sound arrogant—one of the things that gave me confidence in going out on my own was that the fund managers were my clients when I was an analyst, and 1 thought they would not be particularly difficult to compete against".

- Lescarbeau's confidence seemed to border on the irrational. When asked why he didn't delay a split with his partner, who was the money manager of the team, until he had developed his own approach, Lescarbeau replied, "I knew I would come up with something. There was absolutely no doubt in my mind. I had never failed to succeed at anything that I put my mind to, and this was no different."

An honest self-appraisal in respect to confidence may be one of the best predictors of a trader's prospects for success in the markets. At the very least, those who consider changing careers to become traders or risking a sizable portion of their assets in the market should ask themselves whether they have absolute confidence in their ultimate success. Any hesitation in the answer should be viewed as a cautionary flag.

11. Hard Work

The irony is that so many people are drawn to the markets because it seems like an easy way to make a lot of money, yet those who excel tend to be extraordinarily hard workers—almost to a fault. Consider just some of the examples in this book:

- As if running a huge trading company were not enough, Shaw has also founded a number of successful technology companies, provided venture capital funding and support to two computational chemistry software firms, and chaired a presidential advisory committee. Even when he is on a rare vacation, he acknowledges, "I need a few hours of work each day just to keep myself sane."
- Lescarbeau continues to spend long hours doing computer research even though his systems, which require very little time to run, are performing spectacularly well. He continues to work as if these systems were about to become ineffective tomorrow. He never misses a market day, to the point of hobbling across his house in pain on the day of his knee surgery so that he could check on the markets.
- Minervini works six-day workweeks, fourteen-hour trading days, and claims not to have missed a market day in ten years, even when he had pneumonia.
- Cook continues to do regular farm work in addition to spending fifty to sixty hours a week at trading. Moreover, for years after the disastrous trade that brought him to the brink of bankruptcy, Cook worked the equivalent of two full-time jobs.
- Bender not only spends a full day trading in the U.S. markets, but then is up half the night trading the Japanese stock market.

12. Obsessiveness

There is often a fine line between hard work and obsession, a line that is frequently crossed by the Market Wizards. Certainly some of the examples just cited contain elements of obsession. It may well be that a tendency toward obsessiveness in respect to the markets, and often other endeavors as well, is simply a trait associated with success.

13. The Market Wizards Tend to Be Innovators, Not Followers

To list a few examples:

- When Fletcher started his first job, he was given a desk and told to "figure it out." He never stopped. Fletcher has made a career of thinking up and implementing innovative market strategies.
- Bender not only developed his own style of trading options but also created an approach that sought to profit by betting against conventional option models.
- Shaw's entire life has been defined by innovation: the software company he launched as a graduate student; his pioneering work in designing the architecture of supercomputers; the various companies he founded; and his central role in developing the unique complex mathematical trading model used by D. E. Shaw.
- By compiling detailed daily diaries of his market observations for over a decade, Cook was able to develop a slew of original, high-reliability trading strategies.
- Minervini uncovered his own menagerie of chart patterns rather than using the patterns popularized in market books.
- By jotting down all his market observations, Masters was able to design his own catalyst-based trading model.
- Although he was secretive about the details, based on their incredible performance alone, it is quite clear that Lescarbeau's systems are unique.

14. To Be a Winner You Have to Be Willing to Take a Loss

In Watson's words, "You can't be afraid to take a loss. The people who are successful in this business are the people who are willing to lose money."

15. Risk Control

Minervini believes that one of the common mistakes made by novices is that they "spend too much time trying to discover great entry strategies and not enough time on money management." "Containing your losses," he says, "is 90 percent of the battle, regardless of the strategy." Cohen explains the importance of limiting losses as follows: "Most traders make money only in the 50 to 55 percent range. My best trader makes money only 63 percent of the time. That means you're going to be wrong a lot. If that's the case, you better make sure your losses are as small as they can be."

Risk-control methods used by the traders interviewed included the following:

Stop-loss points. Both Minervini and Cook predetermine where they will get out of a trade that goes against them. This approach allows them to limit the potential loss on any position to a well-defined risk level (barring a huge overnight price move). Both Minervini and Cook indicated that the stop point for any trade depends on the expected gain—that is, trades with greater profit potential will use wider stops (accept more risk).

Reducing the position. Cook has a sheet taped to his computer reading: GET SMALLER. "The first thing I do when I'm losing," he says, "is to stop the bleeding." Cohen expresses the virtually identical sentiment: "If you think you're wrong, or if the market is moving against you and you don't know why, take in half. You can always put it on again. If you do that twice, you've taken in three-quarters of your position. Then what's left is no longer a big deal."

Selecting low-risk positions. Some traders rely on very restrictive stock selection conditions to control risk as an alternative to stop-loss liquidation or position reduction (detailed in item 17).

Limiting the initial position size. Cohen cautions, "A common mistake traders make ... is that they take on too big of a position relative to their portfolio. Then when the stock moves against them, the pain becomes too great to handle, and they end up panicking or freezing." On a similar note, Fletcher quotes his mentor, Elliot Wolk, "Never make a bet you can't afford to lose."

Diversification. The more diversified the holdings, the lower the risk. Diversification by itself, however, is not a sufficient risk-control measure, because of the significant correlation of most stocks to the broader market and hence to one another. Also, as discussed in item 53, too much diversification can have significant drawbacks.

Short selling. Although the common perception is that short selling is risky, it can actually be an effective tool for reducing portfolio risk (see item 5 9).

Hedged Strategies. Some traders (Fletcher, Guazzoni, Shaw, and Bender) use methodologies in which positions are hedged from the onset. For these traders, risk control is a matter of restricting leverage, since even a low-risk strategy can become a high-risk trade if the leverage is excessive. (See, for example, discussion of LTCM in the Shaw interview.)

16. You Can't Be Afraid of Risk

Risk control should not be confused with fear of risk. A willingness to accept risk is probably an essential personality trait for a trader. As Watson states, "You have to be willing to accept a certain level of risk, or else you will never pull the trigger." When asked what he looks for when he hires new traders, Cohen replies, "I'm looking for people who are not afraid to take risks."

17. Limiting the Downside by Focusing on Undervalued Stocks

A number of the traders interviewed restrict their stock selection to the universe of undervalued securities. Watson focuses on the stocks with relatively low price/earnings ratios (8 to 12). Lauer will look for stocks that have witnessed market-adjusted declines of at least 50 percent. Okumus buys stocks that have declined 60 percent or more off their highs and are trading at price/earnings ratios under 12. He also prefers to buy stocks with prices as close as possible to book value.

One reason all these traders focus on buying stocks that meet their definition of value is that by doing so they limit the downside. As Lauer explains when talking about using a large price decline as a selection screen, "Right now, I'm only focusing on the question of how I make sure

I don't lose money. I'm not talking about making money yet." Another advantage of buying stocks that are trading at depressed levels is that the stocks in this group that do turn around will often have tremendous upside potential.

18. Value Alone Is Not Enough

It should be stressed that although a number of traders considered undervaluation a necessary condition for purchasing a stock, none of them viewed it as a sufficient condition. There always had to be other compelling reasons for the trade, because a stock could be low priced and stay that way for years. Even if you don't lose much in buying a value stock that just sits there, it could represent a serious investment blunder by tying up capital that can be used much more effectively elsewhere.

19. The Importance of Catalysts

Lauer has six selection criteria, but five are defensive in nature, aimed at capital preservation. All five of these factors can be in place and he would not consider purchasing a stock without the sixth—a catalyst. "The key question," he says, is "what is going to make the stock go up?"

Watson's stock selection process contains two essential steps. First, the identification of stocks that fulfill his value criteria, which is the easy part of the process and merely defines the universe of stocks in which he prospects for buy candidates. Second, the search for catalysts (recent or impending) that will identify which of these value stocks have a compelling reason to move higher over the near term. To discover these catalysts, he conducts extensive communication with companies, as well as their competitors, distributors, and consumers. By definition, every trade requires a catalyst.

Masters has developed an entire trading model based primarily on catalysts. Through years of research and observation, he has been able to find scores of patterns in how stocks respond to catalysts. Although most of these patterns may provide only a small edge by themselves, when grouped together, they help identify high-probability trades.

20. Most Novice Traders Focus on When to Get in and Forget About When to Get Out

When to get out of a position is as important as when to get in. Any market strategy that ignores trade liquidation is by definition incomplete. A liquidation strategy can include one or more of the following elements:

Stop-loss points. Detailed in item 15.

Profit objective. A number of traders interviewed (e.g., Okumus, Cook) will liquidate a stock (or index) if the market reaches their predetermined profit target.

Time stop. A stock (or index) is liquidated if it failsto reach a target within a specified time frame. Both Masters and Cook cited time stops as a helpful trading strategy.

Violation of trade premise. A trade is immediately liquidated if the reason for its implementation is contradicted. For example, when IBM, which Cohen shorted in anticipation of poor earnings, reported better -than-expected earnings, Cohen immediately covered his position. Although he still took a large loss on the trade, the loss would have been significantly greater if he had hesitated.

Counter-to-anticipated market behavior. (See item 21.)

Portfolio considerations. (See item 22.)

Some of these elements may make sense for all traders (e.g., exiting on counter-to-anticipated market behavior); others are very dependent on a trader's style. For example, the use of stops to limit losses is essential to Minervini, who uses a timing-based methodology, but is contradictory to the approach used by Lauer, Okumus, and Watson, who tend to buy undervalued stocks after very sharp declines. (The latter traders, however, would still use stop-loss strategies for short positions, which are subject to open-ended losses.) As another example, profit objectives, which are an integral part of some traders' methodologies, could be detrimental to other traders and investors by limiting profit potential.

21. If Market Behavior Doesn't Conform to Expectations, Get Out

A number of traders mentioned that if the market fails to respond to an event (e.g., earnings report) as expected, they will view it as evidence that they are wrong and liquidate their position. For example, when Intel reported lower earnings, as Lauer anticipated, but then rallied anyway, Lauer covered his short position. In his words: "I may think [it's] ridiculous, but if the news I expected is out, and the market still does not respond as I had anticipated, I am not going to fight it."

When 1 interviewed Cohen, he was bullish on the bond market, which at the time was in a long-term decline. He gave me a number of reasons why he believed the bond market would witness a substantial rebound in the ensuing months, and he implemented a long position as I sat next to him. Over the following few days, the bond market did indeed witness a bounce, but the rally soon faltered, with bond prices sliding to new lows. When I spoke to Cohen on a follow-up phone interview a week after my visit to his firm, I asked him whether he was still long the bond market, which he had been so bullish on several weeks earlier. "No," Cohen replied, "you trade your theory and then let the market tell you whether you are right."

22. The Question of When to Liquidate Depends Not Only on the Stock but Also on Whether a Better Investment Can Be Identified

Investable funds are finite. Continuing to hold one stock position precludes using those funds to purchase another stock. Therefore, it may often make sense to liquidate an investment that still looks sound if an even better investment opportunity exists.

Watson, for example, employs what he calls a pig-at-the-trough philosophy. He is constantly upgrading his portfolio—replacing stocks that he still expects will go higher with other stocks that appear to have an even better return/risk outlook. Similarly, Lauer will often liquidate a stock after it achieves his target of a double, even if he still believes it has significant upside potential, because by that point he will usually be able to identify a better investment opportunity.

Thus, the key question an investor needs to ask regarding a current holding is not "Will the stock move higher?" but rather "Is this stock still a better investment than any other equity I can hold with the same capital?"

23. The Virtue of Patience

Whatever criteria you use to select a stock and determine an entry level, you need to have the patience to wait for those conditions to be met. For example, Okumus will patiently wait for a stock to decline to his "bargain" price level, even if it means missing more than 80 percent of the stocks he wants to buy. In mid-1999, Okumus was only 13 percent invested because, as he stated at the time, "There are no bargains around. I'm not risking the money I'm investing until 1 find stocks that are very cheap."

24. The Importance of Setting Goals

Doctor Kiev, who has worked with both Olympic athletes and professional traders, is a strong advocate of the power of setting goals. He contends that believing that an outcome is possible makes it achievable. Believing in a goal, however, is not sufficient. To achieve a goal, Kiev says, you need not only to believe in it, but also to commit to it. Promising results to others, he maintains, is particularly effective.

Doctor Kiev stresses that exceptional performance requires setting goals that are outside a trader's comfort zone. Thus, the trader seeking to excel needs to continually redefine goals so that they are always a stretch. Traders also need to monitor their performance to make sure they are on track toward reaching their goals and to diagnose what is holding them back if they are not.

25. This Time Is Never Different

Every time there is a market mania, the refrain is heard, "This time is different," followed by some explanation of why the particular bull market will continue, despite already stratospheric prices. When gold soared to near $1,000 an ounce in 1980, the explanation was that gold was "different from every other commodity." Supposedly, the ordinary laws of supply and demand did not apply to gold because of its special role as a store of value in an increasingly inflationary world. (Remember double-digit inflation?) When the Japanese stock market soared in the 1980s, with price/earnings ratios often five to ten times as high as corresponding levels for U.S. companies, the bulls were ready with a reassuring explanation: The Japanese stock market is different because companies hold large blocks of one another's shares, and they rarely sell these holdings.

As this book was being written, there was an explosive rally in technology stocks, particularly Internet issues. Stocks with no earnings, or even a glimmer of the prospect of earnings, were being bid up to incredible levels. Once again, there was no shortage of pundits to explain why this time was different; why earnings were no longer important (at least for these companies). Warnings about the aspects of mania in the current market were mentioned by a number of the traders interviewed. By the time this manuscript was submitted, many of the Internet stocks had already witnessed enormous percentage declines. The message, however, remains relevant because there will always be some market or sector that rekindles the cry, "This time is different." Just remember: It never is.

26. Fundamentals Are Not Bullish or Bearish in a Vacuum; They Are Bullish or Bearish Only Relative Price

A great company could be a terrible investment if its price rise has already more than discounted the bullish fundamentals. Conversely, a company that has been experiencing problems and is the subject of negative news could be a great investment if its price decline has more than discounted the bearish information.

In his interview, Lauer provided a number of excellent examples of this principle, among them Microsoft, an outstanding company in many respects, but one he considered a very poor investment. In Lauer's words, "This business is not about investing in great companies, it's about profiting from inefficiently priced stocks." When asked for her advice to investors, Galante expressed a similar sentiment: "A good company could be a bad stock and vice versa."

27. Successful Investing and Trading Mas Nothing to Do with Forecasting

Lescarbeau, for example, emphasized that he never made any predictions and scoffed at those who claimed to have such abilities. When asked why he laughed when the subject of market forecasting came up, he replied: "I'm laughing about the people who do make predictions about the stock market. They don't know. Nobody knows."

Lauer contrasted the distinction between forecasting and the analysis of known information: "Any investment approach that is heavily reliant on accurate forecasting ... is inherently risky. . . . All that is required for successful investing is the commonsense analysis of today's facts and the courage to act on your convictions."

28. Never Assume a Market Fact Based on What You Read or What Others Say; Verify Everything Yourself

When Cook first inquired about the interpretation of the tick (the number of New York Stock Exchange stocks whose last trade was an uptick, minus the number whose last trade was a downtick), he was told by an experienced broker that if the tick was very high, it was a buy signal. By doing his own research and recording his own observations, he discovered that the truth was exactly the opposite.

Bender began his option-trading career by questioning the very core premises underlying the option pricing models used throughout the industry. Convinced that the conventional wisdom was wrong, he developed a methodology that was actually based on betting against the implications of the option pricing models in wide use.

29. Never, Ever Listen to Other Opinions

To succeed in the markets, it is essential to make your own decisions. Numerous traders cited listening to others as their worst blunder. Walton and Minervini lost their entire investment stake because of this misjudgment. Talking about this experience, Minervini said, "My mistake had been surrendering the decision-making responsibility to someone else." Watson got off cheap, learning this lesson at the bargain basement price of a blown grade on a class project. Cohen talks about someone he knows who has the skill to be a great trader but will never be one because "he refuses to make his own decisions."

30. Beware of Ego

Walton warns, "The odd thing about this industry is that no matter how successful you become, if you let your ego get involved, one bad phone call can put you out of business."

31. The Need for Self-Awareness

Each trader must be aware of personal weaknesses that may impede trading success and make the appropriate adjustments. For example, Walton ultimately realized his weakness was listening to other people's opinions. His awareness of this personal flaw compelled him to make sure that he worked alone, even when the level of assets under management would have seemed to dictate the need for a staff. In addition, to safely vent his tip-following, gambling urges, he set aside a small amount of capital—too small to do any damage—to be used for such trades.

Doctor Kiev describes his work with traders as "a dialogue process to find out what [personal flaws are] impeding a person's performance." Some examples of these personal flaws he helped traders identify included:

- a trader whose bargain-hunting predisposition caused him to miss many good trades because he was always trying to get a slightly better entry price;
- a trader whose scaled-down entry approach was in conflict with his experiencing these trades as a loss, even though they were entered in accordance with his plan;
- a trader who, to his detriment, always kept a partial position after he made the decision to get out because of his anxiety that the stock would go higher after he liquidated.

Awareness alone is not enough; a trader must also be willing to make the necessary changes. Cook, who also works with traders, has seen people with good trading skills fail because they wouldn't deal with their personal weaknesses. One example he offered was a client who was addicted to the excitement of trading on expiration Fridays. Although the trader did well across all other market sessions, these far more numerous small gains were more than swamped by his large losses on the four-per-year expiration Fridays. Despite being made aware of his weakness, the trader refused to change and ultimately wiped out.

32. Don't Get Emotionally Involved

Ironically, although many people are drawn to the markets for excitement, the Market Wizards frequently cite keeping emotion out of trading as essential advice to investors. Watson says, "You have to invest without emotions. If you let emotions get involved, you will make bad decisions."

33. View Personal Problems As a Major Cautionary Flag to Your Trading

Health problems or emotional stress can sometimes decimate a trader's performance. For example, all of Cook's losing periods (after he became a consistent winning trader) coincided with times of personal difficulties (e.g., a painful injury, his father's heart attack). It is a sign of Walton's maturity as a trader that he decided to take a trading hiatus when an impending divorce coincided with a rare losing period. The morale is: Be extremely vigilant to signs of deteriorating trading performance if you are experiencing health problems or other personal difficulties. During such times, it is probably a good idea to cut trading size and to be prepared to stop trading altogether at the first sign of trouble.

34. Analyze Your Past Trades for Possible Insights

Analyzing your past trades might reveal patterns that could be used to improve future performance. For example, in analyzing his past trades, Minervini found that his returns would have been substantially higher if he had capped his losses to a fixed maximum level. This discovery prompted a change in his trading rules that dramatically improved his performance.

35. Don't Worry About Looking Stupid

Never let your market decisions be restricted or influenced by concern over what others might think. As a perfect example of the danger of worrying about other people's opinions, early in his career, Minervini held on to many losing positions long after he decided they should be liquidated because of concern about being teased by his broker.

36. The Danger of Leverage

Lauer learned his lesson about leverage during the October 1987 crash. The problem was not the crash or his stock selection methodology, as his portfolio recovered in due time, but rather his use of leverage, which resulted in a margin call, forcing premature liquidation of his positions. Therefore Lauer's use of leverage (full margin) didn't merely double his loss on the initial decline, but more importantly prevented him from participating in the subsequent recovery.

Ironically, even though Mark Cook won on most of his trades in his initial market endeavor, he wiped out because of excessive leverage. If you are too heavily leveraged, all it takes is one mistake to knock you out of the game.

37. The Importance of Position Size

Superior performance requires not only picking the right stock, but also having the conviction to implement major potential trades in meaningful size. Doctor Kiev, who sees Cohen's trading statistics, said that nearly 100 percent of Cohen's very substantial gains come from 5 percent of his trades. Cohen himself estimates that perhaps only about 55 percent of his trades are winners. Implicit in these statements is that when Cohen bets big, he is usually right. Indeed, his uncanny skill in determining which trades warrant stepping on the accelerator is an essential element in his success.

Lauer makes a similar point when he says, "I tell my guys that if we come up with a good idea, and as a firm we only buy 50,000 or 100,000 shares instead of a million plus, then that trade is a mistake." As another example, even though Lescarbeau is a systematic trader, he will occasionally increase the leverage on trades that he perceives have a particularly high likelihood of winning. Interestingly, he has never lost money on any one of these trades.

The point is that all trades are not the same. Trades that are perceived to have particularly favorable potential relative to risk or a particularly high probability of success should be implemented in a larger size than other trades. Of course, what constitutes "larger size" is relative to each individual, but the concept is as applicable to the trader whose average position size is one hundred shares as it is to the fund manager whose average position size is one million shares.

38. Complexity Is Not a Necessary Ingredient for Success

Guazzoni's initial strategy when he formed his own fund was based on a very simple idea—buying restricted shares at a deep discount. Although the idea was very simple, it achieved the magic combination of high return and very low risk that has eluded far more complex approaches.

39. View Trading As a Vocation, Not a Hobby

As both Cook and Minervini said, "Hobbies cost money." Walton offered similar advice, "Either go at it full force, or don't go at it at all. Don't dabble."

40. Trading, Like Any Other Business Endeavor, Requires a Sound Business Plan

Cook advises that every trader should develop a business plan that answers all the following essential questions:

- What markets will be traded?
- What is the capitalization?
- How will orders be entered?
- What type of drawdown will cause trading cessation and reevaluation?
- What are the profit goals?
- What procedure will be used for analyzing trades?
- How will trading procedures change if personal problems arise?
- How will the working environment be set up?
- What rewards will the trader take for successful trading?
- What will the trader do to continue to improve market skills?

41. Define High-Probability Trades

Although the methodologies of the traders interviewed differ greatly, in their own style, they have all found ways of identifying high-probability trades.

42. Find Low-Risk Opportunities

Many of the traders interviewed have developed methods that focus on identifying low-risk trades. Guazzoni says, "Every period of time has its own opportunities where you can find investments that are extremely discounted and have a very well protected downside."

43. Be Sure You Have a Good Reason for Any Trade You Make

As Cohen explains, buying a stock because it is "too low" or selling it because it is "too high" is not a good reason. Watson paraphrases Peter Lynch's principle that if you can't summarize the reasons why you own a stock in four sentences, you probably shouldn't own it.

44. Use Common Sense in Investing

Taking a cue from his role model, Peter Lynch, Watson is a strong proponent of commonsense research. As he illustrated through numerous examples, the most important research one can often do is simply trying a company's product or visiting its mall outlets in the case of retailers.

45. Buy Stocks That Are Difficult to Buy

Walton says, "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." Minervini says, "Stocks that are ready to blast off are usually very difficult to buy without pushing the market higher." He says that one of the mistakes "less skilled traders" make is "wait[ing] to buy these stocks on a pullback, which never comes."

46. Don't Let a Prior Lower-Priced Liquidation Keep You from Purchasing a Stock That You Would Have Bought Otherwise

Walton considers his willingness to buy back good stocks, even when they are trading higher than where he got out, as one of the changes that helped him succeed as a trader. Minervini stresses the need for having a plan to get back into a trade if you're stopped out. "Otherwise," he says, "you'll often find yourself. . . watching the position go up 50 percent or 100 percent while you're on the sidelines."

47. 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

When a stock is down a lot from where it was purchased, it is very easy for the investor to rationalize, "How can I get out now? I can't lose much more anyway." Even if this is true, this type of thinking can keep money tied up in stocks that are going nowhere, causing the trader to miss other opportunities. Talking about why he dumped some stocks after their prices had already declined as much as 70 percent from where he got in, Walton said: "By cleaning out my portfolio and reinvesting in solid stocks, I made back much more money than I would have if I had kept [these] stocks and waited for a dead cat bounce."

48. You Don't Have to Make All-or-Nothing Trading Decisions

As an illustration of this advice offered by Minervini, if you can't decide whether to take profits on a position, there's nothing wrong with taking profits on part of it.

49. Pay Attention to How a Stock Responds to News

Walton looks for stocks that move higher on good news but don't give much ground on negative news. If a stock responds poorly to negative news, then in Walton's words "[it] hasn't been blessed [by the market]."

50. Insider Buying Is an Important Confirming Condition

The willingness of management or the company to buy its own stock may not be a sufficient condition to buy a stock, but it does provide strong confirmation that the stock is a good investment. A number of traders cited insider buying as a critical element in their stock selection process: Lauer, Okumus, and Watson, to name a few.

Okumus stresses that insider buying statistics need to be viewed in relative terms. "I compare the amount of stock someone buys with his net worth and salary. For example, if the amount he buys is more than his annual salary, I consider that significant." Okumus also points out the necessity of making sure that insider buying actually represents the purchase of new shares, not the exercise of options.

51. Monitor Major Fund Holdings

Lauer explained that the major funds hold such large positions that it will often take months for them to liquidate or significantly reduce the portfolio allocation to a specific stock. Moreover, he points out that there is a substantial overlap in the largest holdings of major mutual funds. These considerations suggest that if fund-holding statistics show that the major funds are beginning to reduce their exposure in a particular stock, it should be viewed as a clue that the given stock is likely to underperform in coming months.

52. Hope Is a Four-Letter Word

Cook advises that if you ever find yourself saying, "I hope this position comes back," get out or reduce your size.

53. The Argument Against Diversification

Diversification is often extolled as a virtue because it is an instrumental tool in reducing risk. This argument is valid insofar as it is generally unwise to risk all your assets on one or two equities, as opposed to spreading the investment across a broader number of diversified stocks. Beyond a certain minimum level, however, diversification may sometimes have negative consequences.

Lauer makes two arguments against diversification. First, if carried far enough, it will guarantee index like performance. Therefore, if a trader's goal is to significantly surpass index performance, then diversification should be limited. Second, Lauer points out that in order to be able to make money in both up and down markets, it is necessary for a trader to decouple his performance from the index, which again means limiting the number of stocks held. Okumus, another antidiversification proponent, explains as follows why he limits his portfolio to approximately ten holdings: "Simple logic: My top ten ideas will always perform better than my top hundred."

The foregoing is not intended as an argument against diversification. Indeed, some minimal diversification is almost always desirable. The point is that although some diversification is beneficial, more diversification may sometimes be detrimental. Each trader needs to consider the appropriate level of diversification as an individual decision.

54. Caution Against Data Mining

If enough data is tested, patterns will arise simply by chance—even in random data. Data mining—letting the computer cycle through data, testing thousands or millions of input combinations in search of profitable patterns—will tend to generate trading models (systems) that look great but have no predictive power. Such hindsight analysis can entice the researcher to trade a worthless system. Shaw avoids this trap by first developing a hypothesis of market behavior to be tested rather than blindly searching the data for patterns.

55. Synergy and Marginal Indicators

Shaw mentioned that although the individual market inefficiencies his firm has identified cannot be traded profitably on their own, they can be combined to identify profit opportunities. The general implication is that it is possible for technical or fundamental indicators that are marginal on their own to provide the basis for a much more reliable indicator when combined.

56. Past Superior Performance Is Only Relevant If the Same Conditions Are Expected to Prevail

It is important to understand why an investment (stock or fund) outperformed in the past. For example, as Lauer pointed out, in the late 1990s a number of the better performing funds owed their superior results to a strategy of buying the most highly capitalized stocks. As a result, the high-cap stocks were bid up to extremely high price/earnings ratios relative to the rest of the market. A new investor expecting these funds to continue to outperform in the future would, in effect, be making an investment bet that was dependent on high-cap stocks becoming even more overpriced relative to the rest of the market.

As commentator George J. Church once wrote, "Every generation has its characteristic folly, but the basic cause is the same: people persist in believing that what has happened in the recent past will go on happening into the indefinite future, even while the ground is shifting under their feet."

57. Popularity Can Destroy a Sound Approach

A classic example of this principle was provided by the 1980sexperience with portfolio insurance (the systematic sale of stock index futures as the value of a stock portfolio declines in order to reduce risk exposure). In the early years of its implementation, portfolio insurance provided a reasonable strategy for investors to limit losses in the event of market declines. As the strategy became more popular, however, it set the stage for its own destruction. By the time of the October 1987 crash, portfolio insurance was in wide usage, which contributed to the domino effect of price declines triggering portfolio insurance selling, which pushed prices still lower, causing more portfolio selling, and so on. It can even be argued that the mere knowledge of the existence of large portfolio insurance sell orders below the market was one of the reasons for the enormous magnitude of the October 19, 1987, decline.

Index funds may well provide a current example of this principle. As Lauer explained, index funds originally made a lot of sense for the investor, providing the opportunity to own a representative piece of the market, with presumably lower risk due to the index's diversification, and a low cost structure and favorable tax treatment (due to low turnover). As index funds outperformed the majority of actively managed funds, however, they attracted steadily expanding investment flows. This investment shift, in turn, created more buying for the stocks in the index at the expense of the rest of the market, which helped the index funds outperform the vast majority of individual stocks, attracting still more assets, and so on. As a result of this process, what started out as a conservative investment has evolved into an investment concentrated in issues trading at high valuations and therefore embedding above-average risk.

Of course, it is impossible to know whether this situation will correct itself by the time this book is published. But if index stocks are still trading at historically high price/earnings ratios relative to the rest of the market at that time, then the same cautionary message would apply.

58. Like a Coin, the Market Has Two Sides—but the Coin Is Unfair

Just as you can bet heads or tails on a coin, you can go long or short a stock. Unlike a normal coin, however, the odds for each side are not equal: The long-term uptrend in stock prices results in a strong negative bias in short-selling trades. As Lescarbeau says, "Shorting stocks is dumb because the odds are stacked against you. The stock market has been rising by over 10 percent a year for many decades. Why would you want to go against that trend?" (Actually, there is a good reason why, which we will get to shortly.)

Another disadvantage to the short side is that the upside is capped. Whereas a well-chosen buy could result in hundreds or even thousands of percent profit on the trade, the most perfect short position is limited to a profit of 100 percent (if the stock goes to zero). Conversely, whereas a long position can't lose more than 100 percent (assuming no use of margin), the loss on a short position is theoretically unlimited.

Finally, with the exception of index products, the system is stacked against short selling. The short seller has to borrow the stock to sell it, an action that introduces the risk of the borrowed stock being called in at a future date, forcing the trader to cover (buy in) the position. Frequently, deliberate attempts to force shorts to cover their positions (short squeezes) can cause overvalued, and even worthless, stocks to rally sharply before collapsing. Thus, the short seller faces the real risk of being right on the trade and still losing money because of an artificially forced liquidation. Another obstacle faced by shorts is that positions can be implemented only on an uptick (when the stock trades up from its last sale price)—a rule that can cause a trade to be executed at a much worse price that the prevailing market price when the order was entered.

59. The Why of Short Selling

With all the disadvantages of short selling, it would appear reasonable to conclude that it is foolhardy to ever go short. Reasonable, but wrong. As proof, consider this amazing fact: thirteen of the fourteen traders interviewed in this book incorporate short selling! (The only exception is Lescarbeau.) Obviously, there must be some very compelling reason for short selling.

The key to understanding the raison d'etre for short selling is to view these trades within the context of the total portfolio rather than as standalone transactions. With all their inherent disadvantages, short positions have one powerful attribute: they are inversely correlated to the rest of the portfolio (they will tend to make money when long holdings are losing and vice versa). This property makes short selling one of the most useful tools for reducing risk.

To understand how short selling can reduce risk, we will compare two hypothetical portfolios. Portfolio A holds only long positions and makes 20 percent for the year. Portfolio B makes all the same trades as Portfolio A, but also adds a smaller component of short trades. To keep the example simple, assume the short positions in Portfolio B exactly break even for the year. Based on the stated assumptions, Portfolio B will also make 20 percent for the year. There is, however, one critical difference: the magnitude of equity declines will tend to be smaller in Portfolio B. Why? Because the short positions in the portfolio will tend to do best when the rest of the portfolio is declining.

In our example, we assumed short positions broke even. If a trader can make a net profit on short positions, then short selling offers the opportunity to both reduce risk and increase return. Actually, short selling offers the opportunity to increase returns without increasing risk, even if the short positions themselves only breakeven. * How? By trading long positions with greater leverage (using margin if the trader is fully invested)—a step that can be taken without increasing risk because the short positions are a hedge against the rest of the portfolio.

To be precise, this statement would be true even for small net losses in the short component of the portfolio, but an adequate explanation is beyond the scope of this book.

It should now be clear why so many of the traders interviewed supplement their long positions with short trades: It allows them to increase their return/risk levels (lower risk, or higher return, or some combination of the two).

If short selling can help reduce portfolio risk, why is it so often considered to be exactly the opposite: a high-risk endeavor? Two reasons. First, short trades are often naively viewed as independent transactions rather than seen in the context of the total portfolio. Second, the open-ended loss exposure of short positions can indeed lead to enormous risk. Fortunately, however, this risk can be controlled, which brings us to our next point.

60. The One Indispensable Rule for Short Selling

Although short selling will tend to reduce portfolio risk, any individual short position is subject to losses far beyond the original capital commitment. A few examples:

- A $10,000 short position in Amazon in June 1998 would have lost $120,000 in seven months.
- A $10,000 short position in Ebay in October 1998 would have lost $230,000 in seven months.
- A $ 10,000 short position in Yahoo in January 1997 would have lost $680,000 in two years.

As these examples make clear, it takes only one bad mistake to wipe out an account on the short side. Because of the theoretically unlimited risk in short positions, the one essential rule for short selling is: Define a specific plan for limiting losses and rigorously adhere to it.

The following are some of the risk-control methods for short positions mentioned by the interviewed traders:

- A short position is liquidated when it reaches a predetermined maximum loss point, even if the trader's bearish analysis is completely unchanged. As Watson says, "I will cover even if I am convinced that the company will ultimately go bankrupt. . . . I'm not going to let a one-percent short in the portfolio turn into a 5 percent loss."
- A short position is limited to a specific maximum percentage of the portfolio. Therefore, as the price of a short position rises, the size of the position would have to be reduced to keep its percentage share of the portfolio from increasing.
- Short positions are treated as short-term trades, often tied to a specific catalyst, such as an earnings report. Win or lose, the trade is liquidated within weeks or even days. For example, Lauer will typically hold long positions for six to twelve months, or even longer, but he will usually be out of short positions within a couple of weeks or less.

61. Identifying Short-Selling Candidates (or Stocks to Avoid for Long-Only Traders)

Galante, whose total focus is on short selling, looks for the following red flags in finding potential shorts:

- high receivables (large outstanding billings for goods and services);
- change in accountants;
- high turnover in chief financial officers;
- a company blaming short sellers for their stock's decline;
- a company completely changing their core business to take advantage of a prevailing hot trend.

The stocks flagged must meet three additional conditions to qualify for an actual short sale:

- very high P/E ratio;
- a catalyst that will make the stock vulnerable over the near term;
- an uptrend that has stalled or reversed.

Watson's ideal short-selling candidate is a high-priced, one product company. He looks for companies whose future sales will be vulnerable because their single or primary product does not live up to promotional claims or because there is no barrier to entry for competitors.

62. Use Options to Express Specific Price Expectations

Prevailing option prices will reflect the assumption that price movements are random. If you have specific expectations about the relative probabilities of a stock's future price movements, then it will frequently be possible to define option trades that offer a higher profit potential (at an equivalent risk level) than buying the stock.

63. Sell Out-of-the-Money Puts in Stocks You Want to Buy

This is a technique used by Okumus that could be very useful to many investors but is probably utilized by very few. The idea is for an investor to sell puts at a strike price at which he would want to buy the stock anyway. This strategy will assure making some profit if the stock fails to decline to the intended buying point and will reduce the cost for the stock by the option premium received if it does reach the intended purchase price.

For example, let's say XYZ Corporation is trading at $24 and you want to buy the stock at $20. Typically, to achieve this investment goal, you would place a buy order for the stock at a price limit of $20. The alternative Okumus suggests is selling $20 puts in the stock. In this way, if the stock fails to decline to your buy price, you will at least make some money from the sale of the $20 puts, which by definition will expire worthless. If, on the other hand, the stock declines to under $20, put buyers will exercise their option and you will end up long the stock at $20, which is the price that you wanted to buy it at anyway. Moreover, in this latter event, your purchase price will be reduced by the premium collected from the sale of the options.

64. Wall Street Research Reports Will Tend to Be Biased

A number of traders mentioned the tendency for Wall Street research reports to be biased. Watson suggests the bias is a result of investment banking relationships—analysts will typically feel implicit pressure to issue buy ratings on companies that are clients of the firm, even if they don't particularly like the stock. Lauer, who was himself an analyst for many years, pointed out the pressure on analysts to issue recommendations that are easily saleable (popular, ultra liquid stocks), not necessarily those with the best return/risk prospects.

65. The Universality of Success

This chapter was intended to summarize the elements of successful trading and investing. I believe, however, that the same traits that lead to success in trading are also instrumental to success in any field. Virtually all the items listed, with the exception of those that are exclusively market specific, would be pertinent as a blueprint for success in any endeavor.