CHAPTER 1

Trading Is an Art, Not a Science

I have an old friend, John Labuszewski, who worked with me at Nikko Securities when I ran the equity futures operation on the Chicago Mercantile Exchange (CME) floor. Labuszewski was the president of Nikko funds and the catalyst for Nikko entering the world of managed futures. He was known throughout Japan because of his past successes with Refco in turning the four major Japanese brokerage houses into Refco's best customers. A wonderful storyteller, John would start all his speaking engagements with a tale based in antiquity.

He would relate how the Romans needed large supplies of wine to fuel the increasingly decadent lifestyle of the age. To get the wine to Rome, it became necessary to create a network for shipping and distribution based on contracts set for future delivery. Much of the finest wine of the day was stored in the best possible vessels for shipping in the entire empire: huge jugs lined with lead, which both made them leak proof and sealed them from the elements. However, the lead in the jugs slowly poisoned the wine, transforming the most expensive commodity into a slow, debilitating death for those who drank it. Labuszewski would thus conclude that futures contracts helped destroy the status quo by poisoning or driving insane the elite citizens and thinkers of the day, ultimately helping to bring down the entire Roman Empire.

I tell that story because most people who trade in the markets don't really understand what futures are all about. Labuszewski would tell that story in order to create a frame of mind that would allow his listeners to change any misconceptions they might have about the subject he was about to discuss—the futures markets. A common perception of someone

who trades the futures markets is that of a big risk taker—the last of the true entrepreneurs, embodying capitalism in its pure essence. The reality is that the futures markets and those who trade them collectively serve one ultimate purpose: They create a liquid vehicle for risk management.

WHAT ARE FUTURES?

When the Chicago Board of Trade (CBOT) and the CME were founded over a century ago, futures markets were created to give farmers and speculators a central place for price discovery. On any given day on the grain floor of the CBOT, many of the old-time grain customers can still be seen doing business, using the contracts in much the same way that they've been used for over 100 years.

However, the world of futures changed in 1971, when Leo Melamed, then chairman of the CME, together with Nobel laureate Milton Friedman, created a revolutionary concept called the International Monetary Market (IMM). They called the end product *financial futures*. This advance in futures no longer entailed a physical delivery of the products traded, but, rather, called for a cash settlement for the underlying contract marked at expiration. This innovative evolution opened the door for institutions and arbitrageurs who had never seen the futures markets as a way to create a legitimate return on capital. In short, it created a new and sophisticated customer base for futures, which has grown dramatically since its inception.

As the use of financial futures proliferated, the number of jobs in the industry that both traded and serviced the markets exploded, starting with local clearinghouses based in Chicago and progressing to large money-center banks based in Europe. Prior to the establishment of the IMM, many of these banks had enjoyed a monopolistic interbank market in both currencies and fixed income, which allowed the spreads in the markets to remain wide—the spread, in this case, being the difference between the bid and the offer, or in reality, pure risk less profit potential.

It became apparent to all those trading at the time that these new markets in Chicago were slowly taking the edge away from their country club network and making the underlying markets much more efficient. That's when every bank with a currency trading operation began to view the markets in Chicago, not as a bastard stepchild, but as a necessary part of pricing every transaction.

WHO USES FUTURES AND WHY?

One of the most-asked questions in this industry is: "Who really uses futures and why?" The conventional answer is: farmers and ranchers looking for

price discovery for their products, speculators and risk takers who have an opinion about direction, and spreaders who spread both intramarket and intermarkets. These are the obvious players, but this falls short of telling us the crucial role each plays in creating an efficient, liquid futures market. Trading is more than learning to buy low and sell high. The seasoned pro knows when each group of participants is entering the market and can usually identify the impact of those orders.

This understanding of players' actions has nothing to do with transparency; it's a matter of access to the right information, which then develops into a gut feeling. Every market has its own nuances, and those who spend day after day watching a given trade are able to capitalize on the adjustments made by the various market forces. For example, good cattle traders understand that hedgers come into the market at given times in the slaughter cycle and create an aberration in prices. These traders know that if they are positioned properly, the market will inevitably open a window of opportunity that they can turn into trading profits.

OPTIONS

As we begin to study options, it becomes immediately apparent that they are a world unto themselves. In fact, if we think of futures as a game of checkers, we would have to regard options as a game of three-dimensional chess. It takes a completely different type of personality to trade options than it does to trade futures on a daily basis. One might make an argument that the personality of a futures trader is that of a great risk-taker and the personality of an options trader is that of a very cerebral, risk-averse individual. That is no longer the case.

Today we are experiencing a marriage of the two worlds, as trading between futures and options becomes more and more intertwined; however, regardless of the incestuous nature of the trading, the financial world continues to look upon the options trader as more quantitative by nature than the futures trader. One reason for this generalization might be that the options markets, and the models that are used to price those markets, are based on pure mathematics. The Black-Scholes model—the definitive model for pricing options created by Myron Scholes and Fischer Black in 1973—or a derivative of the Black-Scholes model is the mathematical formula used in every options trading group and every institution with options exposure in its portfolio. One thing that new traders often don't understand is that these option trades become so large at times, especially around expiration and at month's end, that they move the market in very strange ways. Later, we'll look at how good traders take advantage of the aberrations created by the large options flow at certain times in the cycle.

Who are the end users of the options markets and, more important, why are they using these contracts? This is a question that many novice traders neglect to ask as they venture into a world that is quite foreign to them. It only makes sense to realize that anyone in the capital markets who has exposure to a certain sector of the marketplace is looking for an affordable way to hedge out that exposure, creating a solid risk-to-reward ratio. Individuals use options to write covered calls, enhancing the yield on a stock, or they look to buy puts as an insurance policy against any downturn in their portfolios.

Of course, there are many sophisticated investors who understand the nature of the options markets and use them with greater intensity, but they are the exception rather than the rule and the order flow created by this small minority does not have much market impact. In the fixed-income world, institutions use options to create caps, floors, or collars for interest rate exposure, thus creating the type of leverage that they need and insulating them from any wild fluctuations in price. It is these options strategies that allow the creative mortgage solutions proliferating in the present-day housing market to be engineered.

Some of the largest trades taking place in the entire financial world are done at the CME in the Eurodollar options pit. As the former president of Commerz Futures, a division of Commerzbank of Germany, I saw firsthand the importance of the products and the role that they played in pricing every transaction involving fixed income by the banks' traders. The situation has matured to the point that every major banking institution from around the globe has found that maintaining a presence and monitoring the action in the Chicago markets is not done out of luxury but has become a necessity.

Institutions with equity exposure use options in many different ways. Aside from using the options markets in the traditional ways, institutions, and in particular hedge funds, use the vehicles for creating extra leverage and giving customers and investors an easier way to increase volatility in their portfolios. Many of the new players in the options world are index funds that have looked to enhance their returns either by selling premium against their core positions or by selling premium against a sector position. This strategy gives them more yield per million under management but increases the risk with the investment.

OPTION PREMIUM AND VOLATILITY

Speculators love options because they can buy a call or a put and know exactly what their risk will be by paying a premium. It becomes an insurance policy of sorts and is a much easier way of protecting a portfolio or playing

a direction in the market. Unfortunately, many speculators are not professional traders and don't understand the nuances of the options market, such as time and volatility, which could make the right directional trade into a monetary loser.

One good example of this phenomenon is the market crash of 1987. As a new trader, I was taught that when the market begins to break hard, it is imperative to remain calm and not get caught up in the emotion of the moment—a very difficult thing to do when the world looks like it's coming to an end. I watched as the put market began to trade at price levels that would have taken an Armageddon to enable to break even! Worse yet, I watched in terror as retail customers sent in market orders buying put options at any possible price without understanding the effects of spiking volatility on options premiums. I quickly learned that trading any market without understanding the fundamentals behind the pricing of that market was financial suicide—maybe not an immediate death but one that could lead to a slow, self-inflicted debilitating disease.

Professional options market makers, however, have a whole different mentality and strategy associated with their approach to trading. They are taught to make markets on every strike, and at some exchanges they are obligated to make a two-sided market regardless of their firms' proprietary positions. It's been said that a good options market maker picks up the nickels and dimes in front of the bulldozer. Well, every now and again the bulldozer runs them over, but they've got to be sharp enough to understand how to cover the exposure that enables them to come back tomorrow.

One of the best-kept secrets, which most professionals on the Street don't even know, is that options traders buy premium, both calls and puts, when the market begins to panic. A common misconception is that everyone is selling everything when the market has a huge move down. And why not? Everyone knows that over 80 percent of all options contracts expire worthless. That is definitely not the case with options traders, who are taught to be "gamma long" with the positions that they acquire. Simply put, they are trained to be long premium because volatility will spike higher, pumping up premium levels on all options strikes, regardless of direction.

The best options traders in the world always have themselves hedged out to both the downside and the upside by buying what are generally referred to as *baby puts* and *baby calls* that end up expiring worthless. These are options that are out of the money but are incorporated into a position for a number of reasons, least of which is to allow the risk manager of the firm the comfort of being able to sleep at night.

Myron Scholes, one of the two creators of the Black-Scholes model, was my colleague on the board of directors at the CME for two years. A Nobel laureate and brilliant thinker, Scholes was very fond of saying that there were many options traders over the course of the years who thanked

him for creating the formula that allowed them to make their fortunes. It was an honor to have served with him on the board of directors, and the CME is still blessed to have such a distinguished person in its boardroom.

Most of today's options market makers have evolved into what the Street refers to as *delta-neutral traders.* Delta-neutral options trades are tied to futures, which create a market-neutral strategy allowing traders or investors the luxury of trading pure volatility with no slippage as they enter or exit positions. In short, traders try to capitalize on the speed of movement, or the rate of price swings, which simultaneously provide both opportunity and protection.

Seasoned traders understand that there are only three ways you can trade the market: direction, time, and volatility. All three of these variables are factored into the price of every financial transaction that takes place in the capital markets. As simple as that might sound, it's something that most individual investors and traders just don't recognize. Trading volatility is much different than trading time or trading direction, and anyone looking at the markets conceptually must understand that basic fact. Directional trading, the easiest concept to grasp, allows the new trader to explore the short side of the market, usually for the first time.

We look at directional trading every day as we decide whether to buy or sell stocks, bonds, or any listed vehicle. Trading the volatility of a given market allows investors or traders the opportunity to profit on the movement of the market regardless of direction. Anyone who understands options can trade volatility without being a professional, but the question is whether they're willing to do the homework and crunch the numbers that enable them to take advantage of the pricing of these strategies. When a trader decides to trade time, it usually encompasses strategies that sell out of the money premium or credit spreads in the options marketplace and monitor those positions very carefully. A strategy based on time is usually looking for decay of premium levels as the contracts get closer to expiration. This approach disregards direction and volatility in favor of the length of time left until expiration.

LIQUIDITY

Liquidity is a concept that many have studied for years, but only a few have acquired a realistic notion of the theory. In studying liquidity, we must take into account the fact that there are different types of daily liquidity that traders will encounter. There is the liquidity of a market that we can gauge through the open interest of a given futures contract. This is really a barometer of the health of the contract rather than an indication

of the size that flows through the market. For example, when we first began trading the S&P Mid-Cap 400 and Russell 2000 contracts, it was imperative for open interest levels to be at a minimum of 5,000 contracts before institutions could trade the product. The major end users called this the *critical mass level* needed for the institution to commit its capital resources.

In some cases, the critical mass issue has been mandated by the charter of the institution, which, in many ways, becomes the vanguard of the capital protecting investors from positions put on in illiquid markets. The daily intraday liquidity of the trade gives us an indication of how large day-trading positions can be without much market impact when entering or exiting the trade. One of the best-kept secrets in the trading pits is that it becomes possible to become bigger than the market. This occurs when a day trader acquires a large intraday position and finds it difficult to manage the risk for various reasons, market impact being the greatest one.

There are times when locals move markets as if they were institutions by virtue of the sheer size of the position they have accumulated. Every now and again, I'm asked to explain liquidity to a visiting group of students or dignitaries in the gallery overlooking the trading floor at the CME. I usually ask them to close their eyes and visualize a pool of water, then imagine small streams and large rivers feeding into and out of that pool. Some are large, gushing rivers (Goldman Sachs, Merrill Lynch, etc.), while others are small streams and tributaries. This analogy usually gives the audience I'm addressing a good idea of what liquidity is really about, or at the least, provides a starting point for their education.

If you think about it, the central price discovery mechanism, the pit, and the electronic platform collectively create that liquid pool of capital. Either way, monitoring the liquidity of a contract allows you to witness the liquid flow of funds as it works its way in and out of the market and, more important, how the liquidity is affected by conditions throughout the daily sessions. One of the most important things that hedge fund managers or portfolio managers do before they trade futures contracts is look at the slippage on execution of those contracts. How easy is it for them to enter and exit trades? How much slippage will occur when the trades are put on? And finally, what is the health of the exchange listing the contract? It becomes a function of smart money management on the part of the traders and compliance officers.

Usually, the tools employed include the open interest or the open positions of a given futures contract. But open interest can also be deceptive because a contract or a market with a large number of contracts open doesn't necessarily give you a clear indication of the daily liquidity that you would need to put on a sizable position. This is most evident in futures contracts that are used as a passive investment vehicle; an example of this is

any of the commodity index contracts like the Goldman Sachs Commodity Index (GSCI) or the Commodity Research Bureau (CRB). These contracts have healthy open interest numbers with low daily volume figures, but they also have the market makers and liquidity providers to create huge markets when needed.

Passive positions are put on with a strategic vision and rolled from month to month from quarter to quarter, thus creating a synthetic type of exposure for investors, with huge leverage, rather than a position that they are trying to alter and monitor daily. The GSCI is a contract I traded and brokered during my days on the floor of the CME, but in order to put on a large position it became very important to know when the daily volume would allow such a trade with as little market impact as possible. This was true not only for the contract itself but also for the underlying components that make up the index. But it's got wonderful open interest, and during the rollover of that contract—the physical rolling of positions from the front month to the new front month—we see quite a bit of activity, making that period in the cycle the best time for customers to execute a large order without leaving a big footprint in the marketplace.

Liquidity can make or break a contract. In fact, as new contracts are created by the exchanges, it is the one thing that they will constantly nurture and encourage more than anything else. When the S&P contract was first introduced to the membership at the CME, everyone wore buttons that read "Fifteen minutes please." This was the exchange hierarchy's way of asking all the exchange traders to commit 15 minutes during the day to help support the new contract.

I remember seeing pork belly traders, cattle traders, and currency traders all making markets in a brand-new stock index they had no business trading. Yet there they were, putting on positions fearlessly to help a new exchange concept succeed. Simply put, liquidity and leverage combined are what the exchanges are marketing and selling to the financial services industry. Together, they, the liquidity providers, are the true essence of the CME and every other exchange around the world.

LEVERAGE

Many investors and traders don't fully understand the concept of leverage; therefore, it scares everyone. More and more people tell me that they understand how leverage works—they realize that futures give you the type of leverage that no other financial vehicle gives you—yet these are the same people who will go out and buy an index fund paying 100 percent margin rather than establishing a futures position, which creates synthetic exposure

and gives the investor much more leverage and flexibility. That fact proves to me that people talk about leverage but don't really understand how to use it.

Perhaps the best example of institutional use of leverage in the marketplace is found in the world of index arbitrageurs. Index arbitrage is a strategy that takes advantage of the disparity between the futures price and the underlying cash price of a given index. Whether you're doing an S&P arb, a Nasdaq arb, a Russell arb, or a GSCI arb, the actions and mechanics of the trade are identical; it's the execution of the underlying products that differs. All index arbitrage is basically the same in structure. The only difference is when the arb is executed with a commodity-based index rather than using equities as an underlying market. Either way, the trader is taking advantage of the aberrations based on what you would consider to be a fair value between the futures contracts and the underlying index.

Most arbs are successful because they are able to use the 20-to-1 leverage that futures inherently give them. Without the incredible amount of leverage that's available to these trading desks, they would not be able to put on the enormouse multi-billion-dollar positions that drive the market up or down, especially during expiration and at times when the indexes are being rebalanced.

Leverage also gives the hedge funds the ability to enhance the yield on a given product. This is evidenced by the many index funds being marketed at present that use a synthetic futures position to replicate equity exposure and sell covered calls and credit spreads overlaying the core position. Many of these funds give investors what they consider to be a two- or a three-beta fund, which, in layman's terms, gives investors double or triple the amount of leverage they would normally get through a conventional investment. The most critical element in dealing with leverage as a concept is managing the risk created by the trade.

HEDGING

True hedgers are a completely different breed than the other players in the capital markets universe. Old-time hedgers were exactly what you would expect them to be: farmers, a cattle ranchers, people looking to lock in the future price of their underlying crop or herd. But now hedging has evolved into a strategy that is much more sophisticated than ever in the history of commodity trading. At present, the large hedges that we see moving the market are fund managers who are looking to cover exposure in an entire portfolio without having to upset the balance of that portfolio.

It becomes much more effective and efficient for a portfolio manager with a sizable portfolio to sell futures instead of the underlying cash position in the event of expected market weakness. An example is a portfolio manager at Fidelity or Putnam who would use a short position in the stock index contracts to hedge out any downside exposure to the portfolio without having to sell out individual issues of stock. There are swap traders and forward rate agreement (FRA) traders who hedge out every transaction, turning fixed-rate products for variable-rate products or vice versa, by using the eurodollar futures or options, which have turned what was a small, niche fixed-income contract into the world's largest and most liquid.

Those swap trades—specifically, the flow that comes off of the swap desks of the major money center banks and institutions around the world—have created the largest spreaders marketplace in the world. That's not to say that we still don't see the old-time hedgers using futures for their intended purpose in the agricultural markets.

Some of the old-time houses such as Cargill and Archer Daniels Midland (ADM) are still in the marketplace using the contracts the way they've used them for the past 100-plus years. The questions are, at what point does hedging out the risk make sense, and at what point does the cost of the hedge become an obstacle to profitability? A strategy called *dynamic hedging* was employed during the 1987 stock market crash, which was a trade that sold index futures, regardless of fair value, to cover exposure in a breaking market. The hedging technique that was being incorporated became a self-fulfilling prophecy for a market that was already in a weakened state.

Unfortunately, the strategy added incredible amounts of selling pressure, which helped to break the market. There are many reasons why that happened, most of which have been fixed through a strong cooperative agreement among the exchanges in Chicago and the equity exchanges in New York, with the Federal Reserve acting as ultimate vanguard. But the most important lesson learned from this experience is that at times hedging simply doesn't work. It took a stock market crash for institutions that were new to futures to learn what farmers and ranchers have known forever—that hedging is an art form like no other!

KNOW THE MARKET YOU TRADE

One of the biggest problems that I've seen over the course of the years is that people get caught in bad trades in markets they simply don't understand. Nothing is more painful than seeing good S&P futures traders stuck in a

horrible hog position, having no logical explanation for why and how they got into the position. It is very important to pay close attention to the market that you're trading, so you pick up on the nuances of the trade. It's clear that knowing the players, knowing the participants, and knowing when this flow is coming in and when they're getting out of trades are what separates good traders from *great* traders.

You learn these things over the course of time, but even more important, you learn them through observation and by doing your homework. One of my first employers was a great trader named Bing Sung. Bing was a boy genius, having graduated from the prestigious Phillips Academy in Andover, Massachusetts, at the age of 16, and from Harvard at the age of 18. By the age of 21, he was an associate professor teaching analytic decision making at Harvard.

I considered Bing a mentor. He had both brain power and a great gambler's instinct, a combination that made him one of the best market thinkers I have ever met. Bing went from being an academic at Harvard to helping run the Harvard Endowment Fund. After he had left the fund, I became his assistant on the floor of the CME, trading futures and options for him throughout the course of the day and engaging in a daily Socratic dialogue that taught me more than any university curriculum ever could.

"I ONLY KNOW HALF THE SCORE!"

Many of the lessons that I learned in trading the markets were learned from Bing during those first formative years. In fact, many of the sayings that I use to this day originated as "Bingisms." I find myself, at times, unconsciously using his colorful language to describe events when I do my daily TV shots on Bloomberg or CNBC, and I'm reminded of my early teacher as I hear myself talk.

Spending hours on the phone with Bing gave me plenty of information to process while attempting to execute my clerking duties without an error. Whenever the market began a significant move up or down, Bing would ask for my opinion. As I described to him the technical levels and the flow moving the market, he would invariably say to me, "Jack, my boy, that's only half of the score. It's as if you're telling me that the baseball score is Cubs 3, White Sox . . . silence?" I remember being confused by the comment the first time he said it. I asked myself if it was Bing's attempt at being difficult, but I eventually learned that he was trying to teach me that there was a large order moving the market—we just didn't see it!

I would explain to him that I would see order flow doing one thing or another, that I would look at the board or check through our network and

realize there was an asset allocation, but he would always follow it up with a compliment and then say, "That's still only half of the score." I would respond, "I guess I need to do more homework?" He would usually laugh and in his own colorful way say to me, "Don't worry, sweetie pie, you'll eventually get it!"

Bing was a storehouse of information, showing me how institutional traders think and act and what strategies were driving daily volatility. One of the Bingisms I remember is: "There are over 2,000 rules in the book of trading [an imaginary book he thought up] and over the course of my career, I've only learned 20!" Now that was over 20 years ago. I hope that Bing, as brilliant as he is, would have been able to pick up on at least a thousand of those lessons by now, but I know that if I were to ask him that question today he would say the number is probably no higher than 50. Still, learning those lessons is worthless unless the trader incorporates what has been experienced into the daily routine.

DO YOUR HOMEWORK

Learning a hard-earned lesson in the markets and not using it to become a better trader is a waste of energy and, even worse, a waste of money. But how do you try to find the full score? How do you do your homework in an environment where the market information might not be transparent?

These are questions that all new traders should be asking if they are to regard trading as a serious business rather than a passing hobby. New traders are sometimes so enamored of charts and technical indicators that they neglect to study the real foundation of the price movements. This is where access to a proper information network is vital, and it's likewise vital to keep your eyes and ears open at all times. In fact, I think the best traders are those who hear and see everything around them, then refine and synthesize it into a trade.

In mid-October of 1987, I was on the phone with Bing, and we watched the market start to break hard. For those of us on the floor at that time, it was an experience we'd never forget. Prior to this, Bing and I had participated in markets that went down, and we were successful in making money, but this was a trade that became scary. In fact, when I heard the fear in Bing's voice, I started to become afraid myself. The conversation was no longer centered on whether to buy or sell the market, but rather on how much damage the system could endure. Would the economy seize up? It got to the point where Bing started to be concerned about the entire banking system, which worried me even more. Up until then, as a 26-year-old novice trader, I had thought only about making the right trade.

It had never dawned on me that we might be looking at the potential collapse of the entire financial system as a result of a stock market crash. Fortunately, as we all know, the system didn't collapse. In fact, years later, studies were released proving that futures helped save the system on the way down by being the only place where portfolio managers could limit their risk—they acted as a buffer for a falling market. But what it taught me at the time, and what Bing's concerns taught me, was to never lose respect for the market. It can carry us all through!

That experience also taught me the importance of doing my homework. For months prior to the break, the long end of the interest rate curve was yielding 10 percent, which created a serious competitive risk for the dollars that were being invested in equities. Bing had pointed that out to me time and time again by recognizing an asset allocation order or by noticing volatility in options premiums long before a volatility index (VIX) was created, but it wasn't until we actually witnessed the market reacting to this phenomenon that I began to feel the market as a trader.

THE PETER LYNCH METHOD

Knowing and understanding what you're trading are not new concepts—and this does not just apply to futures. Peter Lynch, who managed Fidelity Magellan, the best-known mutual fund in the 1980s and 1990s, talked about that with regard to stocks. In fact, Lynch's approach to investing is probably the most practical methodology that the average investor could ever adopt. His advice was simple: Don't buy anything that you don't know or understand! I learned from experience that taking a walk through a shopping mall could be just as effective as looking at a company balance sheet, and in many cases, it means much more.

Browsing a mall or a shopping center to see what people are buying will give you an idea of what the trends are, and even more important, it will give you an idea of where future earnings might be. Practical information collected through observation, coupled with due diligence on company management and governance, enables you to form an educated opinion about a stock, its sector, and the economy in general. Better yet, it creates what every trader wants—a high-percentage trade!

I love telling the story about my daughter Emily coming to me with a stock pick—Claire's, a retailer that girls in her age group were frequenting. Emily was 13 years old at the time, and she and her friends spent quite a bit of money at Claire's. Knowing I was a professional trader, she asked questions about what I was doing; as she began to understand the basics of what drives stocks, she quickly developed an opinion. She

urged me to buy stock in Claire's because she thought it was a great store.

Although her purchases looked like junk jewelry to me, I realized over the course of a couple months that it really wasn't junk at all—the girls were spending a lot of money on it! In a last-ditch effort to be the Warren Buffett of the seventh grade, Emily pleaded, "Dad, please, I think you should buy Claire's stock because we see a lot of people there and all our friends are spending all their money in the store." I thought to myself, "Okay, Sweetie, what do you know?" I patted her on the head and assured her that I would take her advice and buy the stock. The next day Claire's announced earnings significantly higher than expectations and the stock was up 10 percent within the first 10 minutes of trading.

Having two teenage children is a retail stock picker's dream because of the nature of the spending habits in their demographic. I find myself constantly asking both my son and my daughter what they're buying and what their friends and classmates are talking about. This gives me not only the parental control necessary to successfully raise teenagers today, but also a knowledge base for a simple investment strategy.

WHAT ARE THE FUNDAMENTALS?

Another of the best-kept secrets on the Street is that many people trading in the markets don't really understand what the underlying contract they're trading is all about. They don't understand the composition of the indexes or the size of a cattle futures contract, but that doesn't keep professionals from placing huge positions in markets that might be a mystery. Case in point: Many of the professional liquidity providers trading the S&P futures contract, both in the pit and electronically, don't understand the basics behind the contract; they don't understand how it is composed or rebalanced and what types of strategies are being engaged in the marketplace. The best traders understand the fundamentals that drive a market on a daily basis, regardless of what they might be trading. When I raised this issue of market knowledge with some of the greatest locals Chicago's trading pits have produced, I got a definitive analogy in response: "I watch television, but I don't necessarily know how the machine really works."

Most average investors and most traders assume that everyone on the floor and in the pit is an expert on the capital market structure. Nothing could be further from the truth. I often tell people that their educated opinion is in many cases better and more informed than those of a majority of the professionals on the trading floors. Trading in a pit environment is much

more physical than sitting and staring at a screen for a good portion of the session. It's very difficult for traders on the floor to get accurate, timely information because their attention is divided between the action taking place in the pit in front of them and the large information wallboard where they might find a headline that would change the pricing of the market at any given time.

THE LEMMING MENTALITY

Back when I was doing institutional brokering, I encountered two of the finest traders that the index arbitrage world ever produced: Vince McLaughlin and Dennis DeCore. The two met at Merrill Lynch as the concept of stock index futures was being introduced into the capital markets. Index arbitrage takes advantage of the disparity in price between the futures market and the underlying cash market, creating the arbitrage. Pioneers in this game, Vince and Dennis, over time, took the strategy to a new level. Later chapters in this book will explore this strategy in more depth, along with the ancillary effects that are being created as a result of the sheer size of the arb positions in the present-day market.

I consider the years that I spent on the phone with Vince and Dennis to be my version of graduate school. The two gave me a good feel for what was going on in the outside world, what was hitting the futures market, and the aberration in pricing that occurred through various corporate events that drove the index one way or the other. Vince and Dennis opened my eyes to a world that I had never been exposed to before. To that point, I had spent my career in the world of futures, and I had never been around or thoroughly understood the equity markets. The two worlds are so different in terms of both culture and regulatory oversight, and these differences have been institutionalized since the creation of the Commodity Futures Trading Commission.

As I now look back on the days I spent with Vince and Dennis, I find it strange how much of their vocabulary and personality worked their way into my market options and attitudes. Dennis, in particular, had a funny way of describing what he saw as a foolish trade. A contrarian by nature, he loved to watch as traders moved the market, creating a stampede of emotions that extended the moves and brought on aberrations in price. He called this movement the "jumping of the lemmings." Whenever the market started running one way or another, Dennis would invariably say to me, "Jack, the lemmings are at it again."

Let me explain: The lemming is a rodent that has been mythologized as being suicidal—it's possible to witness lemmings jumping off cliffs in Norway en masse into the sea. Thus, the lemming has always been associated with a herd mentality, regardless of whether the final outcome is destructive. Dennis hoped for that herd mentality to drive prices into the inefficient condition that allowed his trading desk to generate profits. He often commented on the silliness of traders putting on positions and having enormous amounts of capital at risk because the trader next to them in the pit was doing the same—yet that's exactly what would happen in the market at any given time of the open outcry trading session.

The best example of the lemming mentality is the Nasdaq bubble experienced in the late 1990s. I had never seen a period in the market when more professionals were baffled by what was happening daily in Nasdaq stocks. I saw the most experienced traders in the world fight the tape consistently for the three or four years of the balloon and get to the point physically, emotionally, and financially where an economic disaster was the only thing that would make them break even, let alone make a profit. These were not novice traders and investors; they were seasoned pros who had been in the game for 20 or more years and thought they had a full grasp of what drove price action.

Many of the big bear funds and their bearish market strategists had their day in the sun a few years later, when we watched valuations on some of these tech stocks break down 90 percent from where they had been during the late 1990s. But it was the lemming mentality that drove the market to unforeseen heights and unattainable valuations, and it was a good trader who could recognize and capitalize on the condition that was created. Perhaps the most difficult thing to do as a trader is to be a contrarian and fight the crowd by fading the collective bullish or bearish mood. When day traders see others putting on trades, they feel as if they're missing the boat if they don't have anything on—it's only natural. Every trader who has had any success in the pits has adopted what I call a trader's ego, which will not allow trading profits to be the exclusive domain of the next trader.

One of the most important lessons the lemming mentality actually taught me is to make my own mistakes without following the herd. Why should I get an opinion from someone sitting in an office a thousand miles away from the action instead of using the tools I have at my disposal through observation and analysis? There are many wonderful technicians and market strategists who have educated opinions on market direction or geopolitical factors, but my opinion, based on their work, is the only one that matters. It's my own opinion that will either garner me a profit or turn my analysis into a losing trade.

MAKE YOUR OWN MISTAKES

Every now and then I'll get a call from somebody soliciting a certain stock or a certain strategy over the phone and I'll ask the person why he or she is making that recommendation. After going through an entire sales pitch, the person admits that the only reason this stock or strategy is being touted is because it was on the recommended list of the person's firm. I usually respond to that type of solicitation by saying, "Thank you, but I can make my own mistakes. I don't need your firm or you to make them for me." It always surprises me that people will take their hard-earned money and put it at risk with information that is so often inept and incomplete.

What's really ironic is that these are the same educated, Internet-savvy people who will do months of research before buying a car or go to great lengths to find the right doctor, but they will make a trading decision based on a whim or a gut feeling. Granted, a trader should not trade without a good gut feeling, but it's an educated gut feeling that's needed. A gut feeling that is not supported by the proper homework or analysis is nothing more than a gambler's hunch.

A client of mine in the mid-1990s was an individual with one of the highest net worths to ever trade futures for his own account. A natural-born gambler, he would refer to me as his "walking casino." He was worth well over nine figures and understood the concepts of risk and reward better than anyone else I had ever met, but he preferred a winning trade based solely on his feeling to one requiring days of painstaking analysis. There was nothing he liked more than making money in the market, but it wasn't the profit of the actual trade that excited him as much as being right about the market.

I realized that somebody who had made that kind of money and had been that successful in life didn't really care about the few hundred thousand dollars shifting from a profit to a loss on a daily basis; rather, it was the trader's ego that was involved with every decision he made. It was the pure satisfaction of knowing when he was right and the disappointment when he realized he was in a bad trade and had to cover the position. Such emotions are incomparable! This man made and lost millions of dollars trading through me, but the one thing he would tell you to this very day is that he enjoyed every minute of it because he made every decision himself.

For those who are successful in other businesses, the lure of the futures markets is magnetic. More important, the ability to make an analogy between their chosen profession or business and futures trading is absolutely necessary in order for them to feel the action. One of the best descriptions of the pit that I've ever heard came from this same wealthy gentleman, who

came and watched the markets trade right next to me on the floor of the exchange. He saw the order flow come in and out and watched the pit react to every order. After silently observing the trading for 15 minutes, he turned to me and said, "Oh, well, this is just like the auto parts business." I told him I didn't understand. "Well, Jack" he said, "I would give hub caps away for free until somebody asked me how much hub caps were—then the price went up to $10 apiece."

He had made the analogy between the auto parts business he had built from scratch and the futures market—and it was perfect! He was saying that as demand for hub caps increased with the seasons, the price would go up. As demand dwindled and the way hub caps were used changed, prices would go down. It was no different in the pit. His insight was a revelation of the obvious! But it showed me what had been drowned out by the noise of the pit, offering me a crystal-clear lesson.