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Introduction: Between Scylla and Charybdis

> *"The winds and the waves are always on the side of the ablest navigators."*
>
> Edward Gibbons

This book is written for people of moderate income engaged in risking their personal finances on a speculative venture. It is for the brave new world of stock and futures day trading, spread betting, options hedging, or any activity requiring courage owing to financial and personal risk.

For the purposes of this book, "risk" is defined as the coexistence of danger and opportunity; where there is uncertainty in relation to future outcome. The seductive blend of danger and opportunity has a powerful allure and the challenge of day trading is fraught with dangers, not normally associated with traditional employment. If you have one, two or three degrees, diplomas, MBAs, whatever, you have no advantage over an astute corner shop newspaper vendor or a street flower salesman. In fact, a hypothesis has been suggested to the contrary; that people with professional qualifications need to "unlearn" their cognitive schema to engage the venture unencumbered by predispositions.

The substance of the book has been drawn from two sources: first, from my personal experience of changing professions in my late thirties from a relatively safe career of managing mental health services in London, England, to that of a stock index futures trader; second, from the large volumes of academic research papers and related literature in the fields of experimental psychology, occupational and performance psychology, economics, day trading, and business administration. I hold formal qualifications and training in these fields and have confidence to make valid inferences from training, research and personal experience.

The purpose of this book is to present a synthesis of contributions to the psychology of financial risk taking (I will use the term "trading" as synonymous with "financial risk taking") by numerous authors from the above fields. It will introduce the neophyte trader or speculator to a world of personal growth and learning which is as much of a requirement for competence as is a thorough understanding of market technical analysis.

When I embarked upon my training as a derivatives trader, I read many books by "experts" and I discovered that old concepts were being rebranded with ostentatious new names. Many authors led me to believe that they had "invented" new analytical systems or "discovered" scientific axioms, but I have now come to understand that many systems are combinations of moving averages of varying degrees of complexity. There will always be exceptions to this.

During my novice years of trading, I read Jack Schwager, *Market Wizards* and *The New Market Wizards*, which I highly recommend. I met numerous other "experts" and "wizards" in England who did not quite have the pedigree of Schwager's "Wizards", but nevertheless presented me with a model or paradigm for learning. I did not understand the difference between going "long" or "short" in the market, which will give the reader an idea as to the amount and quality of training that I needed to achieve competence.

ALCHEMY AND WIZARDS

I met my first tutor through a highly complimentary article in a respected national newspaper. The man seemed highly intelligent, had a few endearing idiosyncrasies, and called himself "Chief Wizard". I parted with €9000 for two weeks' tuition and software. Following this course, I discovered that the course content was seriously lacking and the software was archaic.

Whatever reason leads us to train to become traders, there is then the task of finding suitable courses taught by tutors with the personal attributes of integrity, quality and ability. In the USA there are numerous courses taught by recognised traders and there are numerous sources where candidates can access opinions and views of previous attendees. In the UK, trading as a full-time endeavour has only recently become a reality and many candidates have been hoodwinked by charismatic tutors of questionable ability. Essential attributes such as qualifications, experience, and proven trading ability have largely been ignored by candidates, mainly as a result of lack of information and general knowledge.

I refer the reader to Box 1.1 where there is an outline of a course taught in the UK by a tutor calling himself Chief Wizard. I could be accused of inappropriately using this book as a vehicle to "get even" since I was one of many people to be duped by this man. It is a known fact that post-course complaints often betray their underlying motives of subtle revenge towards the disappointing training and tutor. I have no such motives. My intentions are two-fold; first, to raise general awareness of courses taught in the UK and second, to allow the reader to assess the quality of this course on a continuum from unsatisfactory to satisfactory. In other words, it is not my intention to bring Chief Wizard (CW) to his knees; it is my intention to bring the investing public to their senses! The course outlined in Box 1.1 was not written by myself, but was written by a student of Chief Wizard who had the intention of sending the document to trading standards and law enforcement agencies. The document highlights many pertinent issues. I have preserved the document as much as possible in its original form, save for correcting grammatical errors and clarifying convoluted points.

Box 1.1 Derivative's Trading Course of 1998 Sold and Taught by "The Chief Wizard"

Last spring I attended a two-week course in derivatives trading run by the Chief Wizard (CW). The course fee was £5000 and one was also required to purchase software at a cost of £1865. It had since become clear to me that the software itself is out of date and significantly defective, and what little information was gained during the course is almost of no value.

With the software, the buyer receives a book entitled "The Undeclared Secrets of the Stock Market", by the respected veteran trader and market analyst Tom Williams. Most of the relevant information presented by CW in his course is in fact contained in this book. CW tells his students that the book is fraught with deliberate errors in order to wrong foot those in the know. After much build up, he eventually leads his students page by page through the book in order to correct those errors. For the most part, these corrections involve replacing the words "selling" with "buying" and "buying" with "selling". Clearly CW and Williams disagree on whether activities within the market should be referred to by the actions of the outside small time trader or the inside professional. In fact, the terminology is of little real consequence so long as one is consistent. By changing some but not all of these terms, CW has taken a book that has been written with internal consistency, and has made it inconsistent. Other changes had little or no effect on the overall meaning presented by Williams.

CW insisted that his instructions should be followed blindly without question. At the same time he gives us no hard and fast rules as to what to do (this of course would be impossible). Half way through the second week someone pointed out that they still did not know what a futures contract was, and yet they were expected to trade in these instruments. CW became irritated and eventually angry. He repeatedly insisted that it was his job to keep people following the intended path, and those of us with awkward questions were trying to stray from "the path". It seems incredible that CW refused to explain a futures contract.

CW considers himself to be a great teacher, using radical methods to prepare his students for a deadly war or game. During CW's course, students were required to memorize various lists of facts and market occurrences and to be able to reproduce these on command. Amazingly, many people actually believed that they were learning something of value by being put under pressure like this. In my view, anyone spending £500 per day on such a course should be prepared to memorize a dozen or more such lists between the first and second day or else stay at home and save their money. CW dragged this repetitive and puerile process out for two weeks.

Good teaching involves bringing the student to an understanding of the material being learned. CW deals only in indoctrination, by forcing people to memorize lists of words when they have little or no idea of the underlying meaning of those words. In the end, students were left with the ability to fire off lists at speed without really knowing how to recognize these concepts in the real world of derivatives trading.

More than half of CW's course time was taken up by CW talking about himself. He is a blatant racist with a deep-seated hatred of the German people. On one occasion, he stated to the class that he could not allow "Negroes" to attend because they were intellectually inferior and would hold up the rest of the class. This was not so with Asian blacks, however, and one of the two Asians attending this course was made an example of by being tied up then gagged by CW. The travesty was meant to be a joke and a salutary experience for all others who did not pay attention to CW. In addition to these highly offensive actions and statements, he stated that any race capable of the Holocaust must necessarily be irredeemable and "rotten to the core". He takes the silence from the group as tacit agreement. He does not seem to recognize that no one is willing to object, because they have spent several thousand pounds and this more than any thing convinces them that CW must hold the key to substantial wealth.

At other times, he discusses his recent victories in the markets, his politics, how he enjoys spending his wealth, how he metaphorically owns a wheelbarrow to transport his money, the admiration he attracts, his personal struggle for wealth, military training (this seems to hold a suspicious fascination for him), memories of previous lives, the conspiracy behind the death of Princess Diana, his own yachting experiences (including his focus and calm while sailing solo in the English channel during the 1987 hurricane), the shooting of John Kennedy, the selling-out of British industries to foreign interests, and his personal abilities to auto-induce out-of-body experiences.

During one of the days, I kept a time line outlining the topics under discussion. Out of over seven hours of classroom time, just under two minutes were devoted topics related to futures trading. Even this time was taken to answer, in a grudging and patronizing way, the queries raised by three different students (one answer took four seconds). CW's interests in the aforementioned topics took up the rest of the time.

CW employed classic techniques to maintain credibility in the eyes of most of his students. First and foremost, he offered them the hope of attaining great wealth. This made him valuable in the minds of the listeners. Additionally he would express great concern for the welfare of his students (no such concern has been forthcoming since the end of the course). He would act in a grave and serious manner and then suddenly became friendly and easygoing. He would relate stories of his childhood, speaking of deep-rooted fears in an emotional manner. This would endear him to many of the listeners, creating sympathy. He also allowed himself to be overcome with emotion on at least two occasions – again with many students this had the effect of creating a bond of trust. The tactics employed were (frighteningly) not unlike that of a cult leader.

CW created the illusion that his students were learning information at an accelerated rate. Often he would discuss a recent victory on the market, and then take the group through a laborious calculation to determine the profit from a fractured fill. He ran through at least four such calculations. The mathematics would not be beyond a reasonably able 13-year-old, but because of the tedious nature of the calculation and the amount of paper used people felt as if they had been working hard. Following such a calculation, he would remind us that we could not do this sort of trading anyway, but that we should understand the "complex" calculations involved.

At no time during the course was a computer made available to observe technical charts or actual market movement. In fact, technical charts were not used to teach any of the ideas presented. Occasionally CW would produce a photocopied sheet showing a trade he himself had accomplished. Always these trades were carried out using "higher level methods" which we were not privy to. We could not see any evidence of the concepts we had learned in the charts.

There are several people who have benefited from the course. CW himself took in almost 2 million pounds sterling in course fees alone. His personal friends have made money by selling computers and data feeds to his prospective students. CW's broker, another personal friend, is clearly doing very well from the commissions generated by fledgling traders, regardless of the success rate of such trades. There is little evidence to show that these traders are doing anything other than losing money, despite months of paper trading using ideas learned from CW. The implications are obvious.

During the course, my group was presented with many blatant lies. Some of these are as follows:

1. As part of the course, CW sold a software package for £1865 called Volume Spread Analysis (VSA Version 4.3.4) developed by Tom Williams,

a respected author and retired trader. A new version had simultaneously been released by Tom Williams' company called VSA Professional (Version 5). CW deliberately lied by saying VSA 5 was purposely sabotaged with errors in order to wrong foot the professional trader. This was told to us so that we would continue to believe that we possessed the best available version of VSA, namely VSA 4.3.4 – an obsolete software package.

2. CW's motive for lying becomes clear when you discover he bought the full rights to VSA 4.3.4 from T. Williams. CW tells all students that he paid a seven-figure sum for the rights (e.g. in excess of £ 1 000 000). T. Williams has publicly stated that this is a lie.
3. CW tells students that the book "The Undeclared Secrets of the Stock Market" also contain intentional errors designed to wrong foot anyone who obtains the book but does not study with CW.
4. CW tells students that the software VSA 4.3.4 has a secret method of initializing the moving averages – the formula needs to be entered exactly as specified by CW. If the program does not recognize the user, it fails to function correctly.
5. CW's personal friend, John Bollinger, specifically developed Bollinger Bands for VSA 4.3.4.
6. CW informs selected students that he has the ability to initiate out-of-body experiences at will. He can teleport his mind to any location at any time. Often he will travel to the home of a friend and describe to that friend what is happening at his home.
7. The practice and study of derivatives trading involves the use of "systematic vincivism" a neologism coined by CW. He defines this phrase as: "The practice of repeatedly examining an idea or pronouncement to constantly assess its validity." Any student applying this self-styled concept to the course itself will realize by the end of the second day that there is little to be gained from the course. The neologism "vincivism" is synonymous with "empiricism", but is more sonorous and grandiloquent, thus encouraging CW's self-edification and a false belief in his own myth.
8. The trading room at his home (called The Kremlin) is booby trapped with CS gas canisters in case of intrusion. Only bona fide wizards are allowed into the "Inner Circle".

In summary, I feel that CW has taken my money and failed to deliver on the following points:

1. I paid for a course in derivatives trading and at least 85% of my time on the course was taken up with CW's personal opinions of unrelated topics, usually himself and his own achievements.

2. What little information was presented to me is almost useless in the context of real trading.
3. The venue for the course was held on a boat moored on the river Thames near Blackfriars Bridge. This was often uncomfortable, noisy, and the facilities were poor. Chairs were basic and no suitable tables were provided. Considering the amount CW took in fees from my group alone (over £180 000), the use of such a cheap facility is ridiculous.
4. No one that I am in contact with from the course is able to trade successfully using CW's teaching.
5. Two weeks of my time were taken up with a course that could easily have been taken in two days
6. CW refused to explain the nature of basic concepts such as volume and the nature of an index futures contract, which are central to the study of derivatives trading.
7. The software provided is unreliable, incomplete, will not run in conjunction with other software, and often crashes despite running on its own dedicated machine. No course time was devoted to the use of VSA 4.3.4 and the material provided was inadequate.
8. I never received my own copy of the software for which I paid nearly £3000.
9. I have not received an invitation from CW since the course, despite his insistence that he would be inviting us down to his home to observe real time trading.
10. The course literature promises a receipt for course fees but none was given.

CW has now retired to a popular and exclusive seaside area in England and rarely offers training requiring public advertising. How is it possible for so many intelligent people to be convinced by this man and his "helpers" to undertake training? In Chapter 5, entitled "The Psychology of Perceptual Bias", I explain individual and herd phenomena such as overconfidence, the halo effect, misplaced consistency theory, the sunk cost error, and the risky shift, all of which influence us to make inadequate decisions. These decisions create traps that impel us to remain consistent with an incorrect course of action.

In the writing of this book, I freely admit that I have borrowed extensively from research and literature as outlined above, and I have made every effort to credit the originators of the research when appropriate. I have found numerous authors who borrow from undergraduate psychology and business administration courses and often the information is not relevant to trading. For example, mastering statistical testing of a null hypothesis is a standard requirement for psychology undergraduates. One author presented the two statistical tests of "chi square" and "confidence limits" as an inference tool to ascertain trading competence and consistency. I believe these peripheral skills can only help if you have learned them prior to your trading career because non-relevant learning will be an additional and unwarranted stressor to a huge learning curve. Many excellent traders have no mathematics background. In addition, I recently received a flyer for a course on "How to make a business plan for traders". The cost for the three days was US$3500, which is more than one year's MBA tuition fees at the University of Kingston Business School where I had been seconded. The course material was identical to the MBA course apart from the word "trader" liberally applied throughout.

Throughout the ages, people have tried to fulfil their dreams and ambitions and even the smartest of us are gullible. In Amsterdam, Holland, during the sixteenth century, there was an accredited degree course in alchemy from an accredited and respected centre of education. Our own historical ancestor, Dr John Dee, mystic, astrologer, and adviser to Queen Elizabeth I, is reputed to have researched alchemy there. No one had ever turned lead into gold and we now know that turning lead into gold does not fit the facts of empirical quantum mechanics and inorganic chemistry.

Regardless of the lack of evidence, it did not change the fact that people believed it could be done. This belief existed for almost a thousand years. Great halls were filled with people, all discussing how to create gold from base metals. If you could convince somebody that you had done it once, people would listen to you and pay large amounts to learn the secrets of alchemy.

If you are unable to show success at the time, there was always a good reason why it did not work on this occasion. Others would take what the master knew and add to it, to "improve" it; others would try to refute the ideas with ideas of their own; still others would keep parts of the whole concept and discard other parts not to their liking. Some would combine parts of the entire history with other parts into incomprehensible combinations that only they understood but claimed worked. The same herd mentality is at work in these modern times and there are many "experts" who would like to sell you this dream.

THE PSYCHOLOGY OF FINANCIAL RISK TAKING

The psychology of financial risk taking is a theoretical and practical discipline that can be used as a tool to preserve your capital. If you preserve your capital, winnings will take care of themselves. The psychology of trading offers an answer to the question: "Why do traders lose most or all of their money, even when using systems claiming 70% efficacy?"

Clearly, trading is about the person as well as market technical analysis. The overemphasis on mathematical charting was acknowledged by Jesse Livermore in the early 1900s. On page 61 of the book *Reminiscences of a Stock Operator* (by E. Lefévre), it says:

> I should say that a chart helps those who can read it, or rather who can assimilate what they read. The average chart reader, however, is apt to become obsessed with the notion that the dips and peaks and primary and secondary movements are all there is to stock speculation. If he pushes his confidence to its logical limit, he is bound to go broke. There is an extremely able man, a former partner of a well-known Stock Exchange House, who is really a trained mathematician. He is a graduate of a famous technical school. He devised charts based on a very careful and minute study of the behaviour of prices in many markets – stocks, bonds, grain, cotton, money, and so on. He went back years and years and traced the correlations and seasonal movements – oh, everything. He used his charts in his stock trading for years. What he really did was to take advantage of some highly intelligent averaging. They tell me he won regularly until the First World War knocked all precedents into a cocked hat. I heard that he and his large following lost millions before they desisted. But not even a world war can keep the Stock Market from being a bull market when conditions are bullish, or a bear market when conditions are bearish. All that a man needs to know to make money is to appraise conditions.

I am not belittling the importance of technical analysis; I am making explicit the requirement for traders to make a study of their own behaviour. I call this the “paramouncy principle”.

THE PARAMOUNCY PRINCIPLE

The “paramouncy principle” is this: that you are the most important variable in the trading equation. The psychology of trading addresses the “paramouncy principle” in a systematic manner. Implicit in this principle is my view that anyone with average intelligence and the ability to continue learning for many years, will eventually become a successful trader. The ability to be persistent and flexible to new ideas is a personal trait of all the traders interviewed by Jack Schwager in his seminal books.

Most traders lose money because they do not have an understanding of the markets or themselves. They trade without method, strategy or discipline. They fall prey to powerful emotion, which leads to impulsivity and behaviours more akin to gambling than to genuine understanding. They fall prey to perceptual biases that lead to false conclusions and inappropriate actions.

Education is crucial in addressing the “paramouncy principle”, yet most traders prefer courses on technical analysis. Tom Williams, originator of the Wyckoff VSA model, has developed an outstanding technical system, yet he stresses the necessity of method, the requirement of discipline, and the importance of money management. Even armed with this understanding, traders still have the daunting task of identifying the psychological factors that lead to self-defeating behaviours.

A primary factor contributing to a trader's demise is *stress*. In trading, one's money is always on the line, often on a "tick-by-tick" basis, and it is exposed to potential loss. The uncertainty of all that could happen often makes the trader "believe" that certain things must happen. These "beliefs" often interfere with assessment and strategic/tactical planning.

In this mental state or schema[1] traders make substantial errors in judgement and action. A major task for any trader is to preserve capital for more successful trades. This rarely is done well enough. Traders often find that following exiting a trade at a loss, the market returns to the original entry point and then becomes a profit. This frustrating fact leads to self-defeating behaviour and "if only" recriminations. Traders are experts at punishing themselves, and the loss cycle (described in Chapter 3) leads to a self-fulfilling prophecy of failure.

ACTION, ANALYSIS, AND THE BELIEF PARADIGM

Uncertainty regarding future price action causes anxiety and many traders reduce this anxiety by attempting to "predict" and "forecast" the future. When a trader believes prices will rise or fall, the trader takes action. Action follows belief.

The word 'paradigm' comes from Greek *para* – beside, *deiknynai* – to show. This book employs the common usage of the word, which means a model, theory, perception, assumption or frame of reference. The *personal belief paradigm* is how we perceive, understand and interpret the world. A paradigm is a theory, model, or explanation of something else.

Beliefs are very powerful and seductive. Most market technical analysis is biased by a powerful impulse to confirm and strengthen belief. The belief paradigm seeks only confirmation and does not seek contrary evidence. In addition to not seeking contrary evidence, the personal belief paradigm actively denies, discounts, ignores or distorts evidence. The personal belief paradigm has a powerful mechanism of denial. This process of denial acts as a catalyst to elicit powerful emotions, such as fear. Emotions in general and fear in particular, can impair perception and arrest appropriate action based on contrary evidence. The implications for traders are immense.

Research (Schwager, 1989) indicates that traders are poor at price prediction, showing only 35% to 50% accuracy. One only needs to read the *Sunday Times*

[1] Bartlett (1932): during his famous research on memory, Bartlett coined the term "schema". Regarding memory, Bartlett concluded that when we remember a verbal account, the words are never exact. What happens is what we perceive is assimilated into our own structure of meaning, that Bartlett called a "schema", which includes a great deal of general knowledge. Then when a recall is asked for, the subject takes a few significant remembered details and a general emotional attitude to the story, and from the "schema" constructs what the story must have been. The research on "schema" and perceptual biases has profound implication for traders and will be covered in Chapter 5.

newspaper, or other quality broadsheets, to see that the experts have little or no expertise in predicting prices.

Members of all professions sometimes perform poorly, but the poor performance of financial advisers is matched only by the poor judgement of their clients. David Dreman (1979) has produced research in "Contrarian Investment Strategy". Numerous studies show that advisers on equities consistently do worse than the market they are in, even before making allowance for any fee. The same applies to the managers of pension funds, unit trusts, and of the portfolios of insurance companies. The main reason for their poor performance is that they follow the herd.

The continued employment of investment analysts, commodity trading advisers, etc., both by the general public and by large firms with money is an example of false belief paradigms in action, since these "professionals" are known to be worse than useless. Of this, Professor Stuart Sutherland, in his book *Irrationality – The Enemy Within* states: "It is as though a doctor were to be paid for prescribing drugs that were worse for the patient than ones selected at random."

There is evidence presented in Chapter 3 of this book that suggests the probability of success in day trading is increased by abandoning efforts at prediction, and focusing upon recognising the predicates for action. No one can predict with total accuracy what the price will be in the next minute, hour, day, or year, because the underlying catalysts of market actions are fluid and changing. The trader must always be aware of evidence that refutes the reasons for being in the trade and when this evidence is confirmed, the trader must exit the trade without question, regardless of strength of belief of what will or should happen. The process of analysis and refutation is counter to what happens in the psychology of the personal belief paradigms and is something the trader must learn.

Chapter 2 introduces the concepts of trading *competences* and *competencies.* The competencies required to minimise risk, minimise dependence on prediction and minimise the influence of beliefs are examined. To understand the process and influence of these factors on trading behaviour is the first step to trading competence and freedom from the cycle of loss.

The essence of successful trading is this: to know what to do when volume and price spread patterns are recognised, to know with certainty that one will act on those parameters when they do occur, and to let go of belief and prediction in order to focus more clearly on what action is happening in the market, here and now.

REFLECTIONS

I have suffered the hardship of trading losses and the indignity of being hoodwinked by incompetent tutors charging extortionate fees for useless material. Surprising to some, it is an experience I am grateful for. The experience has motivated me to provide affordable and efficacious education for traders. During the writing of this book, I asked myself one question – "Would this book have helped me in taking my first steps to trading competence?" – the answer is yes.

What follows is a navigational chart that will help to guide you safely through the treacherous waters between Scylla and Charybdis.

SUMMARY CHAPTER 1

- Risk is defined as the coexistence of danger and opportunity, where there is uncertainty in relation to future outcome. People wishing to learn trading skills have been hoodwinked by charismatic tutors, some of whom have no formal qualifications, little trading experience, and no proven trading ability. A course taught in England is presented.
- The psychology of financial risk taking is a theoretical and practical discipline that can be used as a tool to preserve your capital.
- The paramouncy principle is introduced. The principle embraces the notion that you are the most important variable in the trading equation. Jesse Livermore's views on the overemphasis and dependence by traders on charting are examined.
- Traders lose money because they do not have an understanding of the markets or themselves, and they trade without method, strategy or discipline. They fall prey to powerful emotions and perceptual biases which lead to gambling type behaviours.
- The concept of analysis and refutation is introduced. Market technical analysis is biased by a powerful impulse to confirm and strengthen belief. Traders often seek only confirmation; they do not seek contrary evidence. The process of analysis and refutation makes explicit the requirement to identify all information that would militate against your position.
- Research by Dreman et al. demonstrates the poor performance of financial advisers, portfolio managers, and pension funds. The public still invest with these professionals regardless of the considerable adverse evidence.
- Prediction of prices by traders is very poor, it is suggested that concentrating on developing plans using calculated probabilities and then taking action only when the preconditions are evident, is an essential skill to be learned by traders.