

Trend Dynamics APPLIED

Practical applications of TREND DYNAMICS insights & ideas for the professional trader

PUBLISHED ONLY FOR GRADUATES OF THE TREND DYNAMICS COURSE :: FEBRUARY 1997



STRATEGIES :: TACTICS :: ANALYSIS

The Effective Trader; or, Samurai & Catfish Hunter

by Joseph Hart

A FRIEND RECENTLY ASKED what is the biggest obstacle to overcome in making the transition from avid student of the stock or futures markets to professional trader. The short answer is, your own perceptions. These you change by internal transformations.

In *Trend Dynamics* and *TD Applied*, my main purpose all along has been to put before you everything I know about trading, with an emphasis, of course, on technical factors. I've set out the Laws of Trend Dynamics and explained where they came from and how they work in day-to-day trading. Along the way I've discussed certain attitudes and psychological factors that I feel to be important. Here, I'd like to talk about those internal transformations—three in particular. As components of trading success they're no less important than technical sophistication or market savvy. In fact, they're what lets us take advantage of the trading edge I've discussed in these pages.

A popular Los Angeles attraction is the La Brea Tar Pits, an ancient pool of tar in which the remains of prehistoric animals—mastodons, giant sloths, saber-tooth tigers—have been trapped and preserved for ages. For the trader, the misperceptions I'll explore here are like tar. Even the traderequivalent of the saber-toothed tiger—acute of sense, quick, fearsomely well defended—risks being trapped in them, to say nothing of the slow-moving sloth or the heavy-limbed mastodon.

Being Intelligent vs. Being Effective

As a beginning trader, I labored for a long time under the illusion that if one were intelligent and creative, and through diligent study acquired a great deal of knowledge about the markets, success would surely follow. I was wrong. In fact, few false beliefs are as insidious, or as common, as this one. This one nearly sank me early on, and badly impeded my progress. My greatest obstacle was to make the transition from market theoretician (one who thinks deeply about how markets work) to market practitioner (one who effectively uses market knowledge to create trading profits).

Intelligent and creative people everywhere are drawn to trading the markets. Many are drawn by the markets' complexity as much as by the prospect of making money; such traders enjoy testing their intelligence against the problems the markets present, and against one another. But as Peter Drucker, the seminal assayer of what makes businesses and business people successful, once wrote,

There seems to be little correlation between a man's effectiveness and his intelligence, his imagination, his knowledge. Brilliant men are often strikingly ineffectual; they fail to realize that brilliant insight alone is not achievement. They have never learned that insights become achievement only through hard systematic work.¹

Most traders come into the trading business burdened with two kinds of baggage that detract from their effectiveness as traders. First, most of us spend 15 or 20 years enmeshed in an educational system where intelligence, insight, and creativity are considered to be achievement enough. But in the world of business, and in trading in particular, the achievement that counts is something altogether different—something that is not at all synonymous with high intelligence. In trading, the kind of achievement that counts is *effectiveness*.

Being intelligent and creative and the having of a great stock of knowledge about price movement is not the same thing as being an effective trader. The two simply do not go hand in hand. The sooner a struggling trader swallows this pill and considers to what degree he or she believes in and acts on this myth, the quicker he or she can get back on course.

Second, as we grow to maturity we pick up a good many erroneous perceptions about the markets that we need to *unlearn* if we're to be successful traders. We need to correct our conceptualizing. In his book *Zen and Japanese Culture* (Princeton: Princeton University Press, 1959), Daisetz Suzuki provides an apt description of the consequences of erroneous conceptualizing. (In this passage, try substituting the phrase "the markets" for the phrase "a mountain".)

Unfortunately, as soon as we begin to grow up we are indoctrinated by every means accessible to us. Because of conceptualization, our sense-experiences inform us with

¹ *The Effective Executive*. New York: Harper & Row, 1966, p. 1.

an incorrect picture of the world. When we see a mountain, we do not see it in its suchness, but we attach to it all kinds of ideas, sometimes purely intellectual, but frequently charged with emotionality. When these envelop the mountain, it is transformed into something monstrous. This is due to our own indoctrination out of our “scholarly” learning and our vested interests, whether individual, political, social, economic, or religious. The picture thus formed is a hideous one, crooked and twisted in every possible way. Instead of living in a world presented to the Primary Nature in its nakedness, we live in an artificial, “cultured” one. The pity is that we are not conscious of the fact. (p. 175).

Most aspiring traders are mired in misperception about how markets really work and what one truly needs to do to trade them effectively. A first step to trading effectiveness is simply to realize and understand that possessing market intelligence is not enough—and isn’t the same thing as being an effective trader. While the role of market theoretician has its place in fostering sound trading plan development, at some point, we need to make the conscious transition to market practitioner.

Being Right & Making Money

Most trading models fall into one of two categories: those designed to forecast, and those designed to make money. Obviously a trader who wants to make money needs to distinguish between them.

Ned Davis, founder of a well respected institutional research firm, published a book in 1991 entitled, *Being Right or Making Money* (Ned Davis, Inc.). In it he says,

Like nearly all novice investors and analysts coming into the investment business, I was convinced back in 1968 that all I had to do was discover the way the investment world worked, develop the best indicators available to forecast changes in the markets, and then have the conviction to shoot straight and gather my profits.

And if I say so without much modesty, my record from 1968 to 1978 was so good at forecasting stock prices that during a “Wall Street Week” broadcast in 1978, Louis Rukeyser said, “Ned Davis has had an outstanding record in recent years...and has been absolutely right about most the major ups and downs...”

The only problem was that at the end of each year, I would total up my capital gains and, unfortunately, I would not owe Uncle Sam much money. Before someone else could question me, I said to myself, “If you are so smart, why aren’t you rich?” It was at about that time (1978–1980) that I began to realize that smarts, hard work, and even a burning desire to “be right” were really not my problem, nor the

solution to my problem. What I realized was that my real problems were a failure to cut losses short, an inability to be disciplined, difficulty admitting mistakes, fear and greed, and a lack of risk-management, none of which had much to do with being right in the stock market world. It was thus a lack of proper investment strategy, not forecasting that was holding me back.

So I set out to get a computer and a good program, and started building timing models that I felt would give me the objectivity, discipline, flexibility, and risk management that I needed to make consistent profits.

And since 1980, my company, Ned Davis Research, Inc. has been dedicated to building timing models that *do not forecast, but simply are designed to make money*. I can tell you, it made a real change in my investment profits, and both Uncle Sam and myself are now much better off. As far as my forecasting of the market, if anything it suffered, because timing models that make money invariably are not nearly as cocky as a crystal ball guru, and they are so concerned with managing any disastrous risks that they try to hit singles and doubles rather than home runs. But I found that not being the top forecaster on Wall Street at any one time was not all that much of a liability. Again my financial well being improved significantly, and the humility and discipline that the timing models forced upon me actually relieved me of a lot of stressful anxiety. The game changed from winning or losing glory and prestige to a serious business designed to make money with less risk... So being right is not really where it's at, since at least as much of your focus should be on risk management tactics and a disciplined strategy. (pp. 1–4. Emphasis added.)

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Davis goes on to say that through his company he's been exposed to highly effective traders, and that

The winners are very flexible and very disciplined, and they're risk managers. While I am not trying to knock the importance of study, hard work, and being right in terms of investment success, the key is how to make money. I still believe that objectivity, flexibility, discipline, and risk management are the keys to making money. (pp.4.)

These passages resonate with me because my experience was so similar. Early on, I considered myself a gifted forecaster of markets; but when I looked at my bottom line I saw few capital gains. It doesn't do the trader much good to forecast markets he's not profiting from trading. Ultimately I came to realize that *models that are designed to make money are substantively different from forecasting models*. Trading models that make money tend to be armored with risk-management safeguards, and are chiefly if

not entirely concerned with generating trading profits. In short, they tend to be focused on making money over and against being right.

Many aspiring traders are also mired in the misperception that being *right* is all-important. Another first step to trading effectiveness, then, is to forget about being right and concentrate on adapting trading concepts, and building and modifying trading models, in which the goal is not to forecast markets but to make and compound trading profits. For most of us this too requires a considerable degree of unlearning.

Thinking Dangerously

One of our Subscribers, a trader in the City, London's financial district, has hung this motto on the wall in his office: "Don't think, it's very dangerous." To someone who esteems his hard-won intellectual understanding of the markets, this statement may seem odd indeed. But to the experienced trader this caution is wisdom itself. *As traders, all of our thinking should go into developing and understanding our trading model, and not into trade execution.*

Good trade execution is simple and should be virtually automatic. Unfortunately, when we start thinking about a position we're about to initiate, we typically introduce stress and doubt—inhibiting distractions in the form of second thoughts or rational misgivings. Or, faced with the uncertainty that every trade presents, we scramble for more information to reduce the uncertainty while the trade passes us by. What should be straightforward is inhibited and messy; what should be consistent is erratic.

The samurai warriors of 16th and 17th century Japan, great swordsmen who engaged in armed battle that often resulted in loss of limb or life, knew keenly just how dangerous thinking can be. A lapse into thinking while engaged in a swordfight was known as a *suki*, literally "a moment of relaxation"; it gave the opponent a momentary advantage. Samurai warriors were taught to look for and strike the enemy the moment he showed a *suki*. Avoiding such lapses into thinking is no less important to the trader working at executing trades consistently than it was to the great samurai swordsman. For both, it's a matter of maintaining concentration.

In *Zen and Japanese Culture*, which I've referred to above, Daisetz T. Suzuki says that the samurai considered the last stage in mastering the art of swordplay was sustaining a specific state of mind that prevented *suki*. Suzuki writes,

"Models that are designed to make money are substantively different than forecasting models."

"As traders, all of our thinking should go into developing and understanding our trading model, and not into trade execution."

To be of no-mind” (*mushin*) means the “everyday mind” (*heiji-shin*), and when this is attained, everything goes on well. In the beginning, one naturally endeavors to do his best in handling the sword, as in learning any other art. The technique has to be mastered. But as soon as his mind is fixed on anything, for instance if he desires to do well, or to display his skill, or to excel others, or if he is too anxiously bent on mastering his art, he is sure to commit more mistakes than are actually necessary. Why? Because his self-consciousness or ego-consciousness is too conspicuously present over the entire range of his attention which fact interferes with a free display of whatever proficiency he has so far acquired or is going to acquire. He must get rid of this obtruding self- or ego-consciousness and apply himself to the work to be done as if nothing particular were taking place at the moment. When things are performed in a state of “no-mind” (*mushin*) or “nothought” (*munen*), which means the absence of all modes of self- or ego-consciousness, the actor is perfectly free from inhibitions and feels nothing thwarting his line of behavior. If he is shooting, he just takes out his bow, puts an arrow to it, stretches the string, fixes his eyes on the target, and when he judges the adjustment to be right he lets the arrow go. He has no feeling of doing anything specifically good or bad, important or trivial; it is as if he hears a sound, turns around, and finds a bird in the court. This is one’s “everyday mind”

“... His self-consciousness or ego-consciousness is too conspicuously present over the entire range of his attention.”

The swordsman is thus advised to retain this state of mentality even when he is engaged in a deadly combat. He forgets the seriousness of his situation. He has no thought of life and death. His is an “immovable mind” (*fudo-shin*). The *fudo-shin* is like the moon reflected in the stream. The waters are in motion all the time, but the moon retains its serenity. The mind moves in response to the ten thousand situations but remains ever the same. The art culminates here. All the scheming of the intellect has been quieted, and no artifice finds room for its demonstration (pp. 147-148).

It isn’t stretching things too far to note obvious parallels between the high art of swordsmanship and our more mundane activity, consistent trade execution. Note, in Suzuki’s discussion, the importance of detachment as to outcome, the self-forgetfulness. We need to cultivate this sort of detachment. When we think about something we should do nearly automatically, we allow the mind to attach itself to outcome and ego-consciousness. Thinking distracts us.

This interference by the mind is well known among high-achievers in athletics. In his book *In the Zone* (New York: Penguin Books, 1995), Michael Murphy describes a typical example:

[World-class athletes] seem to know that conscious thought must be held in abeyance. Catfish Hunter, in describing the perfect game he pitched against the Minnesota Twins in 1968, said, “I wasn’t worried about a perfect game going into the ninth. It was like a dream. I was going on like I was in a daze. *I never thought about it the whole time.* If I’d thought about it I wouldn’t have thrown a perfect game—I know I wouldn’t.” (p. 26. Emphasis added.)

I have repeatedly suggested how important it is to “trade what you see, not what you think.” To trade what one sees is to interpret price action in the absence of all modes of self- or ego-consciousness, uninterrupted by mental intrusions, and guided entirely by your trading plan. It is serene trading—it is trading in the zone.

Summary

A first step to becoming an effective trader is to realize and understand that at some point we must make a transition from market theoretician (synthesizer of market knowledge) to market practitioner (effective user of market knowledge).

Second, the effective trader is unconcerned about being right about the markets or about being a good forecaster; instead, he or she is committed to acquiring, developing, and adopting trading plans specifically designed to making money.

And third, the effective trader has the discipline to execute trades without handicapping himself or herself by *thinking* about the trades. Instead, the successful trader trusts his or her trading plan, and works to eliminate negative mental intrusions into the execution process.

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