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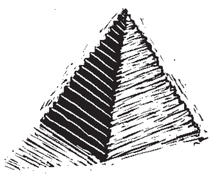

STRATEGIES :: TACTICS :: ANALYSIS

Formless Trading

by Jess Thompson & George Peacock

THE HISTORY of China is often perceived in terms of its glorious culture and storied continuity. Yet whenever central authority waned or barbaric invasions waxed, China suffered wars, upheaval, and disintegration. In virtually every one of the five thousand years from the Sage Emperor period (2852 B.C.E.) up to the end of the Ch'ing (Manchu) dynasty in 1911 C.E., a major battle erupted somewhere in China.

Within this context of interminable strife, warfare became—as Sun Tzu, the famous war strategist, asserted—"the greatest affair of state, the basis of life or death, the Tao to survival or extinction."

5000 YEARS OF DATA

Over that exceptionally long period principles, strategies and tactics for winning in warfare were advanced, tested, amended, and codified. First, victory on the battlefield could determine whether a state survived, and so there was a keen interest among those in power to understand the principles that were associated with victory. In Chinese culture there is an innate reverence for tradition that leads to incorporating the lessons of the past. Then too, in China writing had evolved by the time of even the earliest of these historic events, and their histories were recorded in great detail on bamboo strips that were treasured and preserved by military students and commanders down through the ages. The sheer expanse of Chinese history fostered a continuity in tactical doctrine that provided a wealth of historical data and experience upon which to draw in formulating principles.

This knowledge was codified and documented by Chinese scholars in such major treatises as Sun-Tzu's *Art of War*, the Wu-Tzu, Wei Liao-Tzu, *Methods of the Ssu-ma*, *Questions and Replies Between T'ang T'ai-tsung and Li Wei-kung*, the *Three Strategies* of Huang Shih-kung, and T'ai Kung's *Six Secret Teachings*, and lastly Sun Pin's *Military Methods* (rediscovered in the 1970s).

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When surveying these treatises on conducting warfare, certain organizing principles come to light.

First and foremost, all military activities—whether single battles or extended campaigns—require careful calculation of the probabilities for success. We can recognize this as analogous to our understanding of what our trading edge is, and to assessing risk/reward, win ratios, probabilities associated with the outcome of specific price structures, and both intrinsic and absolute values.

A second operating principle is the importance of a swift and decisive response to opportunity. When opportunities on the battlefield present themselves, they must be seized swiftly before they disappear. Likewise compelling risk/reward situations that appear amidst the chaos of price action disappear quickly as savvy traders react swiftly and decisively to take advantage of the opportunity at hand.

"...flexible response: varying our tactics to suit specific circumstances and situations."

A third organizing principle is that while tactical options and responses can be paired with specific contexts in a general way, no single principle can ever be applicable in every situation. The context of each situation affects the appropriateness of every tactic. Given two situations that are identical except for one or two factors, one may call for avoiding an offensive while the other calls for forceful engagement. This is what we call flexible response: varying our tactics to suit specific circumstances and situations. In our efforts to categorize price action, create and execute trading plans we must avoid becoming inflexible.

A fourth operating principle is that successful war strategies and tactics are more often than not based on deception. In fact, thinking about markets in terms of the deceptive nature of price action can help us understand the laws of *Trend Dynamics* and put them into profitable practice.

In his classic treatise on deception in World War II, *Bodyguard of Lies,* Anthony Cave Brown quotes Winston Churchill on the subject:

> Battles are won by slaughter and manoeuvre. The greater the general, the more he contributes in manoeuvre, the less he demands in slaughter. Nearly all battles which are regarded as the masterpieces of the military art, have been battles of manoeuvre in which very often the enemy has found himself defeated by some novel expedient or device, some queer, swift, unexpected thrust or stratagem. In such battles, the losses of the victors have been small. There is required for the composition of a great commander not only massive common sense and reasoning power, not only imagination, but also an element of legerdemain, an original and sinister touch, which leaves the enemy puzzled as well as beaten. There are many kinds of manoeuvre in war, only some of which take place upon the battlefield. There are manoeuvres in time, in diplomacy, in mechanics, in psychology, all of which are removed from the battlefield but which

react decisively upon it; and the object of all is to find easier ways other than sheer slaughter of achieving the main purpose.[1]

We here recast this passage in trading terms, to make analogies the *Trend Dynamics* trader might find useful as clear as possible:

> Trading battles are won by taking large risks with large amounts of capital or skilled trading across multiple timeframes. The greater the trader, the more he contributes in trades of low risk with high reward, the less he demands in drawdowns. Nearly all trades which are regarded as the masterpieces of the trading art, have been battles of trades of low risk with high reward in which very often the other traders have found themselves defeated by some novel expedient or device, some queer, swift, unexpected thrust or stratagem—the *Trend Dynamics* Third or Seventh Laws, for example. In such battles, the losses of the victors have been small. There is required for the composition of a great trader not only massive common sense and reasoning power, not only imagination, but also an element of legerdemain, an original and sinister touch, which leaves the losing traders puzzled as well as beaten. There are many kinds of manoeuvre in markets, only some of which take place upon the trading floor. There are manoeuvres in time—vide the First Law of *Trend Dynamics*—and in diplomacy—e.g., the operations of the Fed—and in market structure, and in psychology—in knowing oneself—all of which are removed from the trading floor but which react decisively upon it; and the object of all is to find easier ways other than sheer drawdowns and massive risk of achieving high risk/reward percentage returns.

HIGHEST FORM OF DECEPTION

According to Sun-Tzu, the formless—that is, that which is without form—represents the highest realization of deception. To be formless on the battlefield is to reveal no intentions, to present no discernible form to the enemy, the better to deceive them as to our intentions, disposition, and capability with facades and feints, and then striking when and where a strike is least expected.

"In essence, employing the orthodox and unorthodox is the art of ascertaining expectations and creating false expectations and then exploiting them."

To the savvy Chinese commander, underlying the execution of deceptive action is the concept of the orthodox and the unorthodox. Fundamentally, things that are orthodox, whether they be forces, strategies, or tactics, obey basic rules that govern general situations. By contrast the unorthodox deliberately runs contrary to normal expectations. But it's not quite that simple, because everything depends on the enemy's assumptions and evaluations in a particular situation. For example, if the enemy expects a flanking attack (which is normally an unorthodox maneuver) rather than the more orthodox frontal assault, then the flanking attack is the expected and therefore by definition the orthodox in this particular instance. In essence, employing the orthodox and unorthodox is the art of ascertaining expectations and creating false expectations and then exploiting them. (This is pretty much what happens constantly in the markets.)

1. Anthony Cave Brown, *Bodyguard of Lies*. New York: Harper & Row, 1975, p. 5.

These concepts demand that commanders (and traders) operate in a *formless* way. Moreover, the orthodox vs. unorthodox model is rich ground indeed for understanding more about trading and how markets operate. Trading in leveraged futures is like financial warfare. The obvious, the orthodox, strategy is the one the enemy wants you to see, and which therefore may not be important—or if it is important it will almost always be risky.

Anthony Cave Brown quotes Gen. Sir Archibald Wavell, a lifelong student of the art of war, and one of Churchill's commanders-in-chief and key advisor on deceptive strategies in World War II, on orthodox vs. unorthodox strategies. Here we'll directly interpolate trading analogies:

"Practically all of the ruses [unorthodox price action] and stratagems [orthodox price action] of war [markets] are variations or developments of a few simple tricks [the laws and principles of *Trend Dynamics*] that have been practiced by man on man since man was hunted by man."

"First Law: Time conditions and affects the potency of any price movement."

"Third Law: Positive trade expectation occurs when the perception of the probability of a price action event diverges from the actual probability of such an event."

"Seventh Law: Dramatic price movements tend to unfold from price structures that minimize profitable participaton."

Wavell divided these tricks into four rough headings:

"False information [financial news, opinions of others] or disguise [the Third Law]"; "feigned retreat" [RePos, SLRs, springs & upthrusts] while really preparing to attack; the "encouragement of treachery" [rumors and news articles about markets]; and the "weakening of the enemy's morale" [minimizing participation; getting stopped out before the big move starts].

Wavell declared that "every commander [trader] should constantly be considering methods of misleading his opponent [how the market is minimizing participation and fooling the majority of participants], of playing upon his fears, and of disturbing his mental balance [keeping us "full of form"]; and he added that the "elementary principle of all deception is to attract the enemy's [majority of traders'] attention to what you wish [them] to see, and to distract [their] attention from what you do not wish [them] to see. It is by these methods that the skilled conjuror [sophisticated market] obtains his results [minimizes participation]."[1]

The object of all was to:

> …force the enemy [wait for the market] to do something that will assist our operations [create a high reward/risk trade with a good probability of success], e.g. to move his reserves to the wrong place [sell when he should buy] or to refrain from moving to the right place [hesitate and or to induce the enemy to overtrade or otherwise waste his effort].

Like Chinese principles of warfare, the laws of *Trend Dynamics* were formulated from a vast period of observation—a period spanning tens of

1. Brown, 1975, p. 51.

thousands of events (price bars). In TDC 1:2:14–15, Joseph Hart wrote, "...as you accumulate experience you begin to be able to perceive patterns and repetitive formations—you begin to formulate your own broad framework of how markets function." This knowledge is key to our efforts to attack and solve many of the problems associated with trading.

STRUCTURE AS FORM

We can apply the concept of form and formlessness to our trading in at least a couple of useful ways.

First, *form is information.* As price action defines structure, information as to the disposition of market participants becomes knowable. Fig. 34, right, may be considered an orthodox form: The higher bottoms and higher tops define the disposition of strong-hand offensive traders as liquidity becomes identifiable in and around the swing bottoms in an uptrend, where stops accumulate.

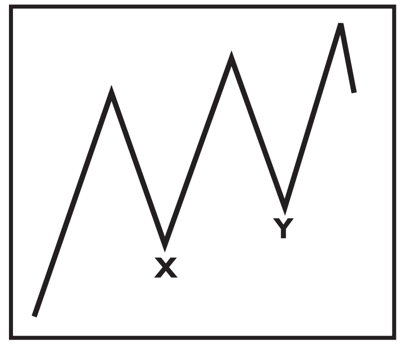

Fig. 34. Orthodox

In Fig. 35, right, the offensive players in a uptrend can be attacked or minimized by the unorthodox price action of a RePo because the form or disposition of the participants can be inferred by the risk/reward implied by trade locations in and around the swing bottom at X. The 18D RePo in Fig. 35, can be seen as an unorthodox attack on the orthodox structure of higher tops and higher bottoms.

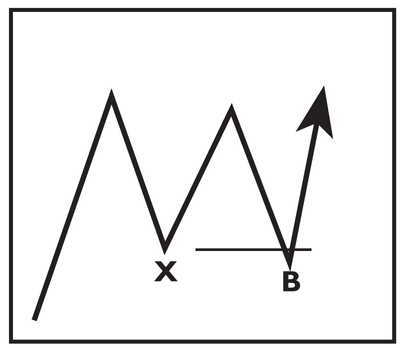

Fig. 35.Unorthodox

Of course if there's a perception or expectation that the higher bottom at X in Fig. 35 is vulnerable to attack, then the *unorthodox* may actually be what is normally construed as the *orthodox* price action seen in Figure 36, right below, which may be an 18D SLR in the lower quadrant. The expected spring never evolves, and the market moves higher.

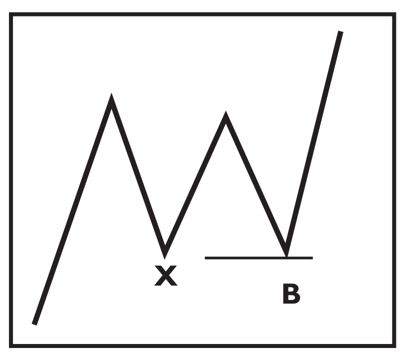

Fig. 36. Unorthodox

In thinking about formless trading, consider how our mental states impact our ability to see and act on whatever the price action we see before us. In TDA 2:2:207–209, Joseph Hart wrote insightfully about our susceptibility to trading with form—in other words trading when we're blinded by distraction, fear, ego, and bias. When we're stalking a market the ideal mental state is one of formlessness—what Bruce Lee called *kime* (tightening the mind). Lee said, "The secret of *kime* is to exclude all extraneous thoughts, thoughts not concerned with achieving your immediate goal." On p. 208 (TDA 2:2 208) this state of mind is described as *mushin* (no-thought) or *munen* (no-mind), the absence of all self- or ego-consciousness, where the trader is perfectly free from inhibitions and feels nothing to thwart his behavior.

What are these distractions? What inhibits and thwarts our natural execution of a trade once price has entered an area where a compelling risk-reward is present? Becoming conscious what inhibits our *kime* when we're stalking a trade is the beginning of solving and removing inhibitions to formless trading.

Here's a list of some factors that can cause us to become self-conscious and to trade with form:

"The secret of *kime* is to exclude all extraneous thoughts, thoughts not concerned with achieving your immediate goal."

1. Becoming rigidly attached to a specific script to the exclusion of other equally viable scripts. We all entertain biases in favor of scripts we've worked out and projected. We can all too easily become biased towards a particular outcome, which can easily lead to our rejecting information that hints at the likelihood of a completely different outcome.

2. Emotional market memory of a series of losses. Such losses can temporarily traumatize us and dangerously impair our execution by causing us to minimize participation in new moves or prematurely to cut short profits on new winning trades.

3. Emotional market memory of missing a great trade opportunity. Missing a big move (or getting stopped out just prior to a big move) when you've been positioned "correctly" can be very destabilizing, and can have a debilitating effect on how we perceive subsequent current price action.

4. Holding a large profitable position. Having executed well and as a result working ourselves into a large profit position easily leads to destabilized perceptions and our dismissal of new information that may be undermine that profitable position.

5. Becoming influenced by the netherworld—*Trend Dynamics*' traders' online shorthand for news and noise. On occasion, especially when outside news is dramatic, it is easy to become influenced by others' perceptions of the markets that may cause us to hesitate in our execution.

6. Becoming overly concerned with perfection and high win-ratios tends to make us focus on price action that may in fact be too intricate to accurately model the uncertainty and chaos inherent in price action, which after all can be said to be an expression of extremes in human emotion. Consider that a compelling risk/reward situation may be more important than high win-ratios; the former leads to execution to avoid opportunity cost, which liberates a trader from any obsession with high win-ratios or trading perfection.

The Chinese treatises on the art of war mentioned above are rich in useful analogies and ideas that can help us sustain correct thinking and consequent actions that further our making trade executions that have positive expectation. In trading, as in waging war, a focus on sustaining formlessness and understanding orthodox vs. unorthodox structures is of paramount importance.

Sun-tzu said that one who knows the enemy [markets] and knows himself will not be endangered in a hundred engagements. Cultivating an awareness of our own susceptibilities, where they come from and what they look like and what they can lead to if unchecked, is the first step. The second is to exercise an iron discipline—and use it to develop safeguards to prevent our falling prey to our own susceptibilities.

Formlessness can also be approached by knowing as much as one can about markets. That means completely and thoroughly understanding the Laws of *Trend Dynamics* and the principles taught in the Course and applying them across multiple timeframes. It means staying flexible and fluid. It means constantly trying to understand what we are not seeing rather than only what we *are* seeing. It means understanding the dominant structure's context for the timeframe we're trading, and recognizing the various manifestations of deception.

"Formlessness...means constantly trying to understand what you are not seeing rather than only what you are seeing. It means understanding the dominant structure's context for the timeframe we're trading, and recognizing the various manifestations of deception."

If we do these two things—if we understand ourselves, and understand the markets in unorthodox ways—we'll have gone a long way toward maintaining formlessness in our market thinking, and in our trading.

Defining Trading Environments & Assessing Trade Quality

by Jerry Guevara

An element of my trading that I consider to be particularly important is recognizing the trading environment for what it is. Having an accurate awareness of both macro- and micro-trading environments is key whether we're considering offensive or defensive tactics. To develop scripts without due consideration for the trading environment is simply to give away a very important market edge.

I consider one of four market phases to be in operation at any given time: a *running trend* market (RT), a *trending* market (T), a *trading range* market (TR), and a *test of the trading range* (TS). Of these the RT is the most powerful phase, the one that presents the best trading opportunities. I consider the TR to be the weakest and most difficult to trade.

A running trend is obviously a market that is at new highs or in a parabolic phase or both. These are the strongest markets—they are trending and give little or no chance of entry. The obvious question is,

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