PRINCIPLES OF GREAT TRADERS

George Coyle

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FOREWORD

Explain something over and over for years and years
and you might get it down to a few pips of pithy poetry
that stick to the soul
like grass burrs on cotton socks.

Navigate oceans of market mysteries for years and years
and you might come to align your sextant
to a few guiding stars that gain lustre
as you weather the pitch and roll of trading.

George Coyle, compulsive culler of quotations,
saver of sayings and accumulator of aphorisms,
herein generously presents his personal curation
of epigrammatic market wisdom and wit.

Come visit his cellar now, again and often.
Walk the racks, inspect the vintages,
imbibe his distillations
and savor the spirits of trading.

Ed Seykota
Austin, Texas
December 1, 2020

INTRODUCTION

This research has been nearly 20 years in the making. As my career has progressed, I have continually read and reread books by and about famous traders. Over time, material stuck, and I started to see a lot of principles in common among the traders. This research is meant to highlight these principles in the words of the traders themselves. The main principles are:

- Cut losers
- Listen to price action/follow price trends
- Ride winners

The secondary principles are:

- Manage emotions
- Don't overtrade

Beyond these practices, the great traders are much more varied in their tactics, but documented evidence of the principles goes back 100 years or more. This leads me to wonder if the "secret" to successful trading isn't just ensuring that the key principles are met. Maybe the rest really doesn't matter so much as long as you abide by them. The more I read, learn, and trade, the more I believe this to be true.

To be clear, I am not a reporter. I am a trader/market researcher and I originally did this research for myself to connect all the dots I was seeing to help my own process. If you'd like to know more including why I am giving this away, please see the "about me" section.

That established, I should define "trader" versus "investor" or other terms. In this case, I will define a trader as someone whose market process includes the principles above. If I had to reduce it further, I would say a proactive process to cut losers meets a healthy respect for price action are what differentiate a trader from a non-trader.

So, what do I hope you take away from this research?

First, while there is no perfect way to do things in the markets, I hope you will come to see the principles as I have and will consider them in your process.

Second, I hope my research helps you on your path to finding your own approach to trading. Or perhaps you will find you are not a trader which could be equally valuable.

Finally, when I consider an investment (whatever the kind), I like to visualize myself standing across from a multi-tiered U.S. Senate testimony style panel of the greatest traders of all time as I present my proposed investment to them. I like to envision their responses to my various proposals. I know certain proposals would lead to universal jeers amongst my hypothetical panel of pros. For example, leveraging 10:1 on one idea with no stop-loss protocol would be universally frowned upon. In my mind's eye, I can see the sidelong glances, hear the sighs and nays, and so on. In short, by knowing how the greats would respond I am more likely to follow their path to success.

In as much as my goal in trading is to make money, I want to be with the greats, not against them. And so, I hope you too will come away with the ability to visualize your own seat across from the greats and know what they would likely say to your ideas, therein adapting your process to something that, at a minimum, does not defy the wisdom of generations of great traders. Few more points…

This research is repetitive at times. Repetition is the whole point, to show you that the same messages show up over and over in the great traders of the past century, and in their own words or the words of those closest to them. Keep in mind that repetition and consistency over time provide the key to what really works. Turn that annoyance into a process that makes you money in markets.

Finally, all of the materials I used throughout this research (see bibliography) provide a lot more depth on the characters involved and their respective styles. Consider reading/viewing/listening to as much as you can to expand your knowledge.

George Coyle
Chicago, Illinois
December 1, 2020

PERFECTION

To begin, let's establish some expectations. Consider the following quotes:

- *"No speculator can be right all the time...the truth is there is no investment which doesn't involve some risk and is not something of a gamble." - Bernard Baruch*
- *"No guide can be 100% right." - Jesse Livermore*
- *"No system of forecasting the movements of the stock market can be infallible." - Humphrey Neill*
- *"...nothing is sure in any field of life." - Gerald Loeb*
- *"You pays your money and you takes your chances." - Richard Dennis*
- *"...what works most of the time is nearly the opposite of what works in the long run." - Bill Eckhardt*
- *"...[trend following] is going to stop working [for periods of time]..." - Jerry Parker*
- *"There is no single trading or investment approach that works every time." - Larry Hite*
- *"In the markets, just about everything works sometimes, and hardly anything works all the time." - Ed Seykota*
- *"Nothing works all the time." - Bruce Kovner*
- *"There are periods of choppy markets when my style of investment is worse than useless." - George Soros*
- *"Reality is...hoping that you can make a few bucks when conditions are good, and praying that you'll survive crashes, plagues, and earthquakes long enough so that someday you'll see the pleasant light of another bull market and have some money left to play it." - Martin Zweig*

If these names don't ring a bell, they will soon. In the meantime, take my word for it that these are some heavy hitters and they're all telling you the same thing. Set your expectations accordingly.

SECRETS

Another thing to consider is the "secret" to successful trading as told by our legends:

- *"I can tell you a couple 'secrets' about purveyors of secrets: 1. There are no secrets. 2. They don't want you to know that." - Ed Seykota*
- *"Trade for the larger intermediate-trend profits and limit your losses. That is the secret, if there is any." - Humphrey Neill*
- *"The single hardest thing I have to do to make people understand how I trade is to convince them how wrong I can be about things, how much of a guess it is...They think that there's some magic involved and that it's not just trial and error...there are no mysteries." - Richard Dennis*
- *"That's the secret of what we do, we're going to continue to do it the same way every single time...we're just gonna keep on selling that breakout and doing those trades..." - Jerry Parker*
- *"I just kept getting up and trying again. That's the real secret of winning." - Larry Hite*
- *"...where I do think I excel is in recognizing my mistakes, you see. And that is the secret to my success..." - George Soros*
- *"The secret for winning in the stock market does not include being right all the time...The key is to lose the least amount of money possible when you are wrong." - William O'Neil*

None of these "secrets" seem that spectacular. With our expectations now, hopefully, firmly grounded in reality, let's get down to it.

CUTTING LOSSES

I believe the single biggest factor responsible for the success of the great traders is that they actively cut their losses. The reason I believe this is because an active method to cut losses is the main differentiator I have found between the legends and everyone else. This may sound incredibly simple, and it is, but a lot of cognitive aspects of human nature make what may seem simple on paper very difficult in reality. While we will discuss the psychological and emotional barriers to trading success shortly, let's start by hearing what our legends have to say one at a time.

Regarding the structure that follows, I have roughly grouped the traders based on their era or other similarities. I mostly stick to chronological order but will finish analysis of a related group before moving to another group even if that causes a "time jump". For example, if group A runs from 1970 to 1990 and group B runs from 1980 to 2000, I will finish group A before moving to group B. Finally, I provide a brief introduction to each trader as we progress, then sharing their quotes. Let's start with a group I refer to as the "Old Timers".

Bernard Baruch:

According to Wikipedia, Bernard Baruch was, "...an American financier, stock investor, philanthropist, statesman, and political consultant." His autobiography, *Baruch My Own Story* profiles Baruch's life adventures and, like many older books, shows not much in human nature changes over time.

Baruch was rather successful financially in his day and was considered one of the greats of his time. If you live near New York, you might notice The City University of New York in Gramercy still bears his name. Let's hear what he has to say about cutting losses:

- *"One of the worst mistakes anyone can make is to hold on blindly and refuse to admit that his judgement has been wrong."*
- *"...if you have made a mistake...admit it immediately and take your loss."*
- *"Don't expect to be right all the time. If you have made a mistake, cut your losses as quickly as possible."*
- *"...in the stock market, the first loss is usually the smallest."*

<u>Jesse Livermore:</u>

Next up is Jesse Livermore. Livermore was a famed speculator from the early 1900s. He made and lost several fortunes. While his story doesn't end so well (he killed himself at the age of 63), he is one of the greats mentioned most frequently by his modern-day equivalents.

More than a few of the traders from Jack Schwager's *Market Wizards* books have mentioned Livermore as an inspiration and have said that *Reminiscences of a Stock Operator* (a disguised biography of Livermore) is a must for anyone seeking to learn about trading and the markets. Like Baruch, Livermore was a big advocate of cutting losers:

- *"The speculator has to insure himself against considerable losses by taking the first small loss."*
- *"Profits take care of themselves but losses never do."*
- *"...protect yourself by selling your stock before the loss assumes larger proportions."*

<u>Humphrey Neill:</u>

As I was doing my research, I found that legendary trader Nicholas Darvas (more on him soon) was a fan of Humphrey Neill's *Tape Reading and Market Tactics*, so much so that he read it repeatedly for inspiration. Thus, I grabbed a copy of the book. It turned out to be a great find. Here is what he had to say regarding cutting losers:

- *"No one may ever hope to become so expert that he never takes a loss."*
- *"Why, then, continue stubbornly to stick it [losing position] out?"*
- *"Countless losses must be accepted: the problem is to limit the losses."*
- *"If you cannot lose cheerfully, do not trade in the market!"*

Gerald Loeb:

Gerald Loeb was another trader that I had never heard of before. I discovered him in one of the books of William O'Neil, the founder of Investor's Business Daily. Darvas, also, was said to be a fan of Loeb. As with Neill, Loeb proved a terrific find. Here is what Loeb advocated regarding cutting losers:

- *"Cutting losses is the one and only rule of markets that can be taught with the assurance that it is always the correct thing to do."*
- *"Losses must always be 'cut'. They must always be cut quickly, long before they become of any financial consequences."*
- *"If the stock declines, it should be sold at a small and quick loss."*
- *"After the elimination of a stock in this manner, the transaction must be, in a sense, forgotten."*

Nicolas Darvas:

And now we get to Nicolas Darvas. I learned about Darvas, and his books, from a trend follower friend when I was twenty-three. Ed Seykota (coming soon) also mentioned Darvas as an influence.

Darvas was a ballroom dancer who traveled the world and started trading on the side. After many false starts and bad outcomes, which he documents in an entertaining and painfully honest fashion in his various books, Darvas morphed his style. The style he ultimately landed on, which made him his fortune, contained the principles described in this research. Let's hear what Darvas thinks about cutting losers:

- *"I have discovered no loss-free Nirvana."*
- *"Why not accept my mistakes realistically and sell immediately at a small loss?"*
- *"A non-gambler must get out when his stocks fall."*
- *"...there is no such thing as cannot in the market...any stock can do anything...I was bound to be wrong half of the time...the first step I took in that direction was to adopt what I called my quick-loss weapon."*

- *"When the [prices] started to tumble downwards, that was the time to close the show and sell out. My trailing stop-loss, which I moved up behind the rising price of the stock, should take care of this automatically."*
- *"I built a fortune...with the use of a single tool: the trailing stop loss."*

Let's pause for a second. The above is a pretty consistent message from the Old Timers. And this evidence comes over a significant time span. But it doesn't stop there! Let's move forward to our next significant group that advocated the same things starting in the late 1960s and early 1970s. We will refer to this group as the Chicago Trend Traders.

Richard Dennis:

Richard Dennis is probably as close to a Horatio Alger story as one can get in reality. He started trading in 1970 with $400 and, in the next decade or so, turned that $400 into somewhere near $200mm (yes, you read that right!). Let's hear from Dennis:

- *"After all is said and done, you have to minimize your losses and try to preserve capital..."*
- *"You should always have a worst case point [stop loss on a trade]. The only choice should be to get out quicker."*
- *"Any time I make a trade I do have a worst case scenario stop loss."*

Bill Eckhardt:

Dennis' partner in crime was his childhood friend William (Bill) Eckhardt. Eckhardt was a PhD candidate at the University of Chicago who got tired of pursuing his PhD and took Dennis up on an offer to come trade. He never finished his PhD. Here is what Eckhardt has to say on cutting losses.

- *"Perhaps the most fundamental principle of successful trading: Cut your losses short and let your profits run."*

Eckhardt went on to form Eckhardt Trading Company, which is still active today. Since 1991, he has accomplished a compound annual growth rate (CAGR) of over 11% with a maximum drawdown (DD) of less than 30%!

Jerry Parker:

Dennis and Eckhardt debated whether they could train successful traders and ultimately decided to settle the debate in reality. They called the trainees "Turtles." Jerry Parker is often considered the most successful of the Turtles. I have been fortunate to get to know Jerry a bit so perhaps I am biased, but his trading knowledge and willingness to share is incredible (see acknowledgments and The Systematic Investor podcast). Here is what he thinks about cutting losses.

- *"I'll throw that trade away if it goes down X% and my predetermined small loss gets hit, its gone. I have no love and...emotional investment in this trade."*
- *"[I'm] Never going to take large losses..."*
- *"We have the stop loss, we're immune [to big losses]"*

Parker founded Chesapeake Capital Corporation which is still active today and, like Eckhardt, boasts one of the best CAGR/DD ratios!

Larry Hite:

Larry Hite is another Market Wizard and hedge fund manager who achieved tremendous success in the markets. Larry has been in charge of several investment firms over the years. The most recent of these is ISAM, a multi-billion dollar trend follower. As I was doing my research, Larry published his book, *The Rule.* I picked up a copy and saw that his message and success aligned with the others. Let's hear what he has to say about cutting losses.

- *"Put simply: When something is not going well, stop doing it."*
- *"You see, the first thing for any organism, for any animal, is survival. Cutting losses on anything gives the chance to endure. That's Spock-like logic, simple math, simple physics..."*

- *"...what if you cut your losses quickly once values started to drop, so you wouldn't risk more than you wanted?"*
- *"Cut your losses and stay with your winners. That is my credo for building wealth and achieving goals of all kinds."*

<u>Trend Followers:</u>

I am going to digress for a moment. Dennis, Eckhardt, Parker, the other Turtles, and Hite are mostly categorized as trend followers. As you can probably infer, they follow trends (in prices). This usually results in riding winners and cutting losers.

There are many long-standing trend followers who advocate the same message as the guys above. Much has been written about them in the terrific books of Jack Schwager and Michael Covel (which I recommend reading). In as much as I want to keep the train moving, I decided not to go down the trend follower rabbit hole here. Suffice it to say that, if you study trend followers, you will find a lot of people advocating in favor of cutting losers. Here are a few names to explore if you are so inclined:

- AlphaSimplex
- AQR
- Campbell & Co.
- DUNN Capital
- FORT LP
- ISAM
- Millburn
- Transtrend
- Winton

While the Chicago Trend Traders were thriving in Chicago, some 800 miles away, in Princeton, New Jersey, another group, whom we will refer to as the Commodities Corp Traders, was experiencing similar success using the same methods at the famed Commodities Corp.

Commodities Corp:

If you've studied successful traders, you've probably heard about Commodities Corp (CC). Many brand name traders worked for or were affiliated with CC, including Michael Marcus, Bruce Kovner, Paul Tudor Jones, Louis Bacon, and Ed Seykota. When this many success stories can all be tied to one place, I believe it deserves attention.

CC was founded in the late 1960s by Helmut Weymar. After completing a PhD and working for Nabisco (a food company) helping to predict and hedge commodity prices, Weymar decided to set up a trading firm. His plan was to use experts on market fundamentals.

Armed with only fundamentals, by 1971 CC had lost over half its initial capital. In light of this, CC management decided to change their approach. Part of that change involved formalizing the guidelines of Amos Hostetter, their proclaimed resident commodities guru.

Amos Hostetter was alleged to have made money consistently in commodity trading for 50 years straight. At his urging, CC began to codify his rules into what would become a mechanical trading system – one of the original trend following systems – that governed CC's discretionary traders. Let's hear what Hostetter had to say about cutting losses:

Amos Hostetter:

- *"There is never any objection to taking a loss."*
- *"Take care of your losses and the profits will take care of themselves."*
- *"...a trader should place strong emphasis on keeping his losses small."*
- *"When in doubt, get out."*

After Hostetter's death, CC employees created a book, *Amos Hostetter; A Successful Speculator's Approach to Commodities Trading,* that summarized their colleague's wisdom. This book was to be used to train future traders at CC. Morris Markowitz was the primary author and the quotes above come from the book - this applies anywhere I quote Hostetter.

Ed Seykota:

Next up is Ed Seykota. Seykota was also profiled in the original *Market Wizards* book and, according to Schwager, realized a 250,000 percent return in 16 years (yes, you read that right!).

Ed also did some consulting for CC. And, like Hostetter, Seykota was mentioned by Michael Marcus (coming up next) as one of the key people responsible for his success.

As an aside, I have some personal experience with Ed. Ed runs a website, www.seykota.com, where, among many other things, he responds to emails from the masses. After reading a good amount of Ed's responses, I took it upon myself to read all of his Q&A and aggregate it into a guide on his wisdom. The result of that work can be found here:

> https://www.seykota.com/tt/Aggregation/Seykota_FAQ-1.html

As a result of my work, I got to know Ed to a degree. Perhaps I am biased given all of this but, in my opinion, my aggregation of Ed's words is one of the best ways to become familiar with the mechanics of successful trading. It is all direct from the keyboard of the man who many have referred to as a trading deity. Let's see what Ed has to say on cutting losses:

- *"Cutting losses refers to the general notion of protecting yourself from further damage."*
- *"Stop losses provide an automatic way to cut losses."*
- *"Three important activities are: placing stops, placing stops and placing stops."*
- *"Risk control has to do with your willingness to allow your stop to do its job."*
- *"All [Ed's systems] use stops and all stops trail the price."*

Michael Marcus:

Michael Marcus was the Market Wizard surveyed in the first chapter of Schwager's original book. Marcus turned $30k into $80 million according to Schwager (yes, you read that right!). He was, according to many, CC's most successful trader. Let's hear from Marcus on cutting losses.

- *"Perhaps the most important rule is to hold on to your winners and cut your losers."*
- *"...always use stops. I mean actually put them in, because that commits you to get out at a certain point."*

<u>Bruce Kovner:</u>

As we work forward in time in the Commodities Corp Traders camp, the next stop is Bruce Kovner. You probably know Kovner ran famed hedge fund Caxton and is a billionaire. You may not know his career started at CC and that he was trained by Michael Marcus (who in turn was trained by Seykota and Hostetter as we have seen - considering this and the Turtle experiment, the evidence would appear to support the conclusion that trading can be taught and learned). Let's hear what Kovner has to say.

- *"I have a predetermined stop. That is the only way I can sleep. I know where I'm getting out before I get in."*
- *"...as a day-in, day-out process, taking losses does not bother me."*

So far, we have covered:

- The Old Timers: Baruch, Livermore, Neill, Loeb, and Darvas
- The Chicago Trend Traders: Dennis, Eckhardt, Parker, and the Turtles
- Larry Hite and various other trend followers
- The Commodities Corp Traders: Hostetter, Seykota, Marcus, and Kovner

The evidence that cutting losses is essential to great trading over a long time span is clearly building. But it doesn't end there.

As stated earlier, after leaving CC, Kovner launched Caxton which started as a "macro" hedge fund. While definitions vary, macro basically describes a fund that can trade any asset class long or short. Of course, trend following CTAs have the same flexibility. The key difference is usually that a designated trend follower doesn't care at all about fundamentals while a macro trader does (or at least they say they do in the press).

Regardless, Kovner, as a macro trader, provides an ideal segue into our next segment, The Macro Traders.

<u>George Soros:</u>

If you're on earth, you've probably heard of George Soros. Whatever you might feel about Soros' politics, it is hard to deny he is a great trader. There were roughly 32 billion reasons to think this prior to his giving away much of his fortune. Let's hear what George thinks about cutting losers:

- *"If I had to sum up my practical skills I would use one word, survival."*
- *"...I have a strong critical faculty. I am not a professional security analyst. I would rather call myself an insecurity analyst...I recognize that I may be wrong. This makes me insecure. My sense of insecurity keeps me alert, always ready to correct my errors."*
- *"My approach works not by making valid predictions but by allowing me to correct false ones."*
- *"To others, being wrong is a source of shame; to me, recognizing my mistakes is a source of pride. Once we realize that imperfect understanding is the human condition, there is no shame in being wrong, only in failing to correct our mistakes."*
- *"...where I do think I excel is in recognizing my mistakes, you see. And that is the secret to my success. The key insight that I have reached is recognition of the inherent fallibility of human thought."*

While the above comments aren't necessarily 100% clear, consider what many of our Old Timers said about "mistakes" in the market and correcting said mistakes (head back to the Old Timers section if you need a refresher). It would appear Soros is using the Old Timer vernacular. Also, consider what Soros' coworkers had to say about him:

- *"Soros is the best loss taker I have ever seen...If a trade doesn't work, he's confident enough about his ability to win on other trades that he can easily walk away from the position." – Stan Druckenmiller*
- *"George Soros...has no emotional attachment to an idea...When a trade is wrong, he will just cut it, move on, and do something else." - Colm O'Shea*

Bottom line, Soros is not only telling us that he believes in cutting losers, he is telling us it is the secret to his success!

Stan Druckenmiller:

Stan Druckenmiller was Soros' protégé and then partner. He is lauded as the "greatest money-making machine of all time" by his peers. Unlike many of the others in this research, Druckenmiller isn't quite as explicit in his commentary on cutting losses. In the material I researched, I didn't find an instance of him referring to cutting losses or using stops specifically. However, if you connect the dots, the message becomes clear.

First, Druckenmiller was a huge fan of Soros. Druckenmiller says of him:

- *"...George Soros had become my idol. He seemed to be about twenty years ahead of me in implementing the trading philosophy I had adopted..."*
- *"In my opinion, George Soros is the greatest investor that ever lived."*

We know from the previous section on Soros that Soros viewed correcting his mistakes as the secret to his success. We also know Druckenmiller had the same overall philosophy as Soros and viewed him as the greatest of all time. To share a philosophy with someone, and revere him as the greatest, but to not share the "secret" sauce seems highly unlikely.

Further, consider the following quotes from Druckenmiller about his own process:

- *"One of the strengths in my investment returns over time, was being open minded."*

- *"...as my wife and others will tell you [about me], he believes something on Monday and, two weeks later, he changes his mind..."*
- *"I've always believed markets are smarter than I am, they send out a message, and then, if I listen to them properly, no matter how powerful my thesis if they're [markets] screaming something else, it's telling me, 'you've gotta reevaluate, you've gotta reevaluate'...you've gotta be open minded."*

Clearly, Druckenmiller believes in reevaluating if prices are going against him and he is quick to change his mind. If you had a position for a reason and changed your mind, it would logically follow that you would change your position. Scott Bessent (former Soros CIO/Druckenmiller coworker) confirmed this contention:

- *"Stan's better at changing his mind than anybody I've ever seen...one of the great things about Stan is that he can and does turn on a dime. To paraphrase John Maynard Keynes, when the facts change, he changes his positions."*

<u>Paul Tudor Jones:</u>

Next up is another household name, Paul Tudor Jones. Jones runs a large hedge fund and is a billionaire as a result. Let's see what he has to say on cutting losers:

- *"The most important rule of trading is to play great defense, not great offense."*
- *"Don't focus on making money; focus on protecting what you have."*
- *"If I have positions going against me, I get right out."*
- *"I have a mental stop. If it hits that number, I am out no matter what."*
- *"If you have a losing position that is making you uncomfortable, the solution is very simple: Get out, because you can always get back in."*

There is a famous picture of Jones with a sign posted above his desk that reads, "*Losers average losers."* Presumably, Jones wanted that message to be front and center while he was at the helm so he wouldn't forget. Food for thought!

More Macro:

While I've had some difficulty procuring enough substantial evidence to include them here, I often come across things that imply other household name macro types use these methods.

For example, a 2019 Bloomberg article citing anonymous investors said Chase Coleman's (Tiger Global) success came from, *"...pressing winners and quickly cutting losers - skills he learned from [Julian] Robertson."*

While comments like this probably don't come across as anything special to the average reader, that simple statement takes on a whole new meaning in the context of this research. Let's keep chugging along and focus now on a group I call the Stock Market Traders.

Martin Zweig:

First up is Martin (Marty) Zweig. He spent years running the top-rated market newsletter, which evolved into an investment management business. Zweig was also one of the most often mentioned newsletter writers by the various Market Wizards. Perhaps Bruce Kovner best summarized Zweig:

- *"I like Marty Zweig. He uses excellent risk control. Unlike some other gurus, he doesn't believe he is predicting the future; he is simply observing what is happening and making rational bets."*

Let's see what Zweig thinks of cutting losers:

- *"According to my rulebook, the only consistent way to make money in the markets is to cut losses and run with profits."*
- *"...it is sheer folly to let losses run wild. Remember: Your first loss is your best loss!"*

- *"Don't refuse to take a loss because of your ego...That lesson is important enough to repeat for emphasis. Don't cling to a stock because you can't afford to bruise your ego by selling at a loss. Remember, no one wins all the time."*

<u>William O'Neil:</u>

In addition to being a Market Wizard, William O'Neil founded *Investor's Business Daily*, and published several books. Let's hear from him:

- *"You must always protect your investment account...cutting losses is absolutely essential."*
- *"...if you don't cut every loss quickly, sooner or later you'll suffer some very large losses."*
- *"...big losses will cause you to lose your confidence, which you absolutely cannot let happen if you expect to continue investing."*
- *"Think of a number of controlled losses as your tuition to Wall Street."*

<u>Mark Minervini:</u>

Mark Minervini is another Market Wizard. Jack Schwager called Minervini's performance, "*astounding*." Let's hear from Minervini:

- *"Regardless of your methodology or approach to stock investing, there is only one way to protect your portfolio from a large loss, and that is to sell when you have a small loss before it snowballs into a huge one. In three decades of trading, I have not found a better way."*
- *"A stop-loss regime is essential."*
- *"The old adage holds true: your first loss is your best loss."*

That's a lot of evidence from very successful traders in favor of cutting losses. Whatever you may feel about the concept, my hope is you are now at least considering a method to cut losers in your process.

Having established whether to cut losers, we must face the question of how to do it. The short answer is there is no right way. There are some guidelines that we can take from our legends (explored later), but each approach has to be custom-tailored to your personal preference. As Ed Seykota succinctly summarized when asked for the perfect trading system:

- *"There is no 'best system' for everyone, just as there is no best car or best wife."*

More broadly, if you find yourself wanting to be told every facet of a trading plan by another, you might consider if trading is right for you. Gerald Loeb perhaps said it best:

- *"...after experimenting with trading, many may convince themselves that they are not cut out for it and that they are better off devoting all their time to their own particular business. I think a great deal has been gained if one determines that once and for all..."*

Having covered the most common principle, let's move on to the next: price action.

PRICE ACTION

Price action is the second most frequently cited principle amongst our legends. Some of them call it trend following. Others refer to it as listening to what the market is telling you. Regardless of the specific terminology used, the message is, listen to the message prices are sending and don't fight that message. Our legends analyze, respect, and utilize price action and price trends in their approaches.

As you likely realize, cutting losses is, to some degree, a subset of price action. In order to have a loss, the price has to be moving against your entry point. However, I decided that cutting losses should stand on its own for two reasons. First, it is the most common principle and, I believe, is really the driving force behind trading success. Second, cutting losses is so against human nature and conventional wisdom that the idea deserves more emphasis. It takes great effort to defy your own nature! Let's hear from our legends.

Bernard Baruch:

- *"With rare exceptions, stocks are high because they are good, and stocks are low because they are of doubtful value."*
- *"Many a novice will sell something he has a profit in to protect something in which he has a loss. Since the good stock usually has gone down the least, or may even show a profit, it is psychologically easy to let go. With a bad stock the loss is likely to be heavy and the impulse is to hold on to it in order to recover what has been lost. Actually, the procedure one should follow is to sell the bad stock and keep the good stock."*

Jesse Livermore:

- *"Behind these major movements is an irresistible force."*
- *"That is all one needs to know, it is not good to be too curious about all the reasons behind price movements. You risk the danger of clouding your mind with non-essentials. Just recognize that the movement is there and take advantage of it by steering your speculative ship along with the tide. Do not argue with the condition, and most of all, do not try to combat it"*

- *"Markets are never wrong - opinions often are."*
- *"...ignore personal opinion and apply strict attention to the action of the market itself."*
- *"...don't back your judgement* 'UNTIL THE ACTION OF THE MARKET ITSELF CONFIRMS YOUR OPINION.'" *[Uppercase in the original.]*
- *"Of course there is always a reason for the fluctuations, but the tape does not concern itself with the why and wherefore. It doesn't go into explanations...Your business with the tape is now not to-morrow. The reason can wait."*

Humphrey Neill:

- *"We cannot know what the insiders intend to do, but we can see their orders on the tape when they execute them. That is why my plea is for every one of us to have no mere opinions of his own, but to allow the action of the market to tell him what is passing."*
- *"Market action - the buying and selling of stocks - is recorded on the tape. To the uninitiated eye and brain the tape means little...To the student...it offers opportunities..."*
- *"The ticker tape is simply a record of human nature passing in review."*
- *"...let us disregard hunches and wild conjectures. If he buys and sells, the record of his transactions will be on the tape."*
- *"We must make our interpretation from the record."*
- *"...do not argue with the tape."*

Gerald Loeb:

- *"In my opinion, the primary factor in securing market profits lies in sensing the general trend."*
- *"...effort should be concentrated first on deciding the trend..."*

- *"Of all the factors that go to make up a well-rounded opinion on the general market trend and, more especially, the individual stocks selected for commitment, I would easily rank the actual price movement first."*
- *"I feel that practically all relevant factors, important and otherwise, are registered in the market's behavior..."*
- *"I am inclined to favor doing one's major forecasting from the tape or, to put it another way, from the price movement."*
- *"...price is the all-important consideration..."*

<u>Nicolas Darvas:</u>

- *"Stocks did not fly like balloons in any direction. As if attracted by a magnet, they had a defined upward or downward trend which, once established, tended to continue."*
- *"As to my basic strategy, I decided I would always do this: I would just jog along with an upward trend...as the trend continued, I would buy more."*
- *"I was fascinated to realize that my buying, based purely on the stock's behavior, enabled me to profit from a proposed merger without knowing anything about it. I was an insider without actually being one."*
- *"I could not hear what people said, but I could see what they did."*
- *"When the trend reversed? I would run like a thief."*

<u>Richard Dennis:</u>

- *"At first, I thought that intelligence was reality and price the appearance, but after a while I saw that price is the reality and intelligence is the appearance."*
- *"[My system] is as pure a price trend following system as we could develop. It leaves out things like moving averages and cycles, which it seems to me were irrelevant; systematically misleading in the quest to identify price trends."*
- *"The market being in a trend is the main thing that eventually gets us in a trade."*
- *"The trend is your friend."*

- *"If I see a trend developing, I know eventually I'll have to get in."*
- *"...go with the trend."*

Jerry Parker:

- *"...you should follow price...quit trying to be an expert...follow prices, follow trend..."*
- "*...if you were to ask me my positions, they're totally determined by the trend."*

Larry Hite:

- *"...I don't make money because I know anything. I only make money because I do what the market tells me to do."*
- *"Global financial markets are not best...traded by stories but rather by numbers (which are the only facts)."*
- *"I don't need a million charts or thousands of pieces of fundamental data to tell me that Microsoft's cloud business is booming - the trend is telling me. It's telling you too."*
- *"...I ask you to look carefully at the trend and numbers...No one can know the future, but what are those trends and numbers telling you?"*
- *"Here's how it works: To spot a rising trend, you look at where the price is now relative to where it has been. So for example, if the price of a commodity or stock is higher than it has been for 40 or 50 days...you can buy and ride this trend"*
- *"The one-year high of the company's stock price is all I want to know - the numbers."*

Trend Followers:

As in the last section, there are a lot of trend followers (see prior section for the list) who clearly subscribe to the idea of following prices. It is, after all, part of their name.

Amos Hostetter:

- *"The market, to be commanded, must be obeyed."*
- *"Trade with the trend, and you will be right more often than you are wrong."*
- *"...post daily charts...and develop a feel for trends."*
- *"One should always hold in mind the direction of the...trends. The major trend is the most powerful."*
- *"...never underestimate the power of a major trend."*
- *"Follow the fundamentals in your trading but only if and as long as the charts [trend] do not cast a negative vote."*
- *"Is the contemplated trade in the direction of [the] trend?" - A question from Hostetter's Trade Checklist. If the answer was no, he wouldn't trade.*

Ed Seykota:

- *"The best indicator I know is Trend. The other good ones are Trend and Trend."*
- *"In order of importance to me are: (1) the long-term trend..."*
- *"Trade with trend."*

Michael Marcus:

- *"...I did make one terrible mistake...I impulsively took my profits...I was trying to be fancy instead of staying with the trend."*
- *"Ed [Seykota] provided an excellent role model...Ed said, 'The trend is down, and I'm going to stay short until the trend changes.' I learned patience from him in the way he followed the trend."*
- *"...I was befriended by a very kind, knowledgeable, and successful semitretired broker at Shearson named Amos Hostetter...Amos reinforced a lot of the things Ed taught me. I was getting the same principles from two people."*
- *"The lessons I had learned from Seykota about staying in markets with major trends really paid off."*

- *"...the chart must show that the market is moving in the direction that the fundamentals suggest..."*

Bruce Kovner:

- *"Technical analysis reflects the vote of the entire marketplace..."*
- *"It is very important for me to study the details of price action to see if I can observe something about how everybody is voting."*
- *"The market usually leads because there are people who know more than you do."*

George Soros:

- *"...even a cursory look at commodity, stock, and currency markets confirms that trends are the rule rather than the exception."*
- *"We position the fund [Quantum] to take advantage of larger trends...Most of the time I am a trend follower."*
- *"There are periods of choppy markets when my style of investment is worse than useless."*

Stan Druckenmiller:

- *"My first mentor, Speros Dreylles back in Pittsburgh, used to say, 'a hundred million Frenchman can't be wrong', and that was his saying that the voice of the market was always correct and I need to listen to it. And it was true..."*
- *"...I also learned, that...when the trend started to go up, that's when I'm supposed to pile in."*
- *"Volatility is only good if it is part of a trend and it is giving you entry points within a trend."*
- *"When you're going up and down, but there's no real trend, that's a nightmare."*

Paul Tudor Jones:

- *"I see the younger generation hampered by the need to understand and rationalize why something should go up or down. Usually, by the time that becomes self-evident, the move is already over. When I got into the business, there was so little information on fundamentals, and what little information one could get was largely imperfect. We learned just to go with the chart. Why work when Mr. Market can do it for you?"*
- *"While I spend a significant amount of my time on analytics and collecting fundamental information, at the end of the day, I am a slave to the tape and proud of it."*
- *"I always believe that prices move first and fundamentals come second."*
- *"My metric for everything I look at is the 200-day moving average of closing prices."*
- *"Never play macho man with the market."*

Martin Zweig:

- *"I'm a trend follower, not a trend fighter."*
- *"I don't believe in swimming against the tide."*
- *"The idea is to get in harmony with the market. It's suicidal to fight trends. They have a higher probability of continuing than not."*
- *"I can't overemphasize the importance of staying with the trend in the market, being in gear with the tape, and not fighting the major movements. Fighting the tape is an open invitation to disaster."*
- *"The market can humble any and all of us at any time. Your best protection is to stay in gear with the trend. In other words, don't fight the tape."*
- *"To me, the 'tape' is the final arbiter of any investment decision. I have a cardinal rule: 'never fight the tape.'"*
- *"...I absolutely and utterly refuse to fight a major trend in the market."*

William O'Neil:

- *"Ignore personal opinions about the market. Instead, study the day-to-day price and volume changes..."*

Mark Minervini:

- *"...I would never bet on my fundamental ideas alone without confirmation from the actual price action of the underlying stock."*
- *"I never go against the long-term trend."*
- *"Let the strength of the market tell you where to put your money, not your personal opinion..."*

Let's keep right on moving to the next section.

RIDING WINNERS

If you're quick to take a loss, odds are you're going to lose more frequently than you win. Or so logic would imply. Not so coincidentally, the pros tell us the same:

George Soros:

- *"George [Soros] has a terrible batting average – it's below 50 percent and possibly below 30 percent..." - Scott Bessent*

Stan Druckenmiller:

- *"I've learned many things from him [Soros], but perhaps the most significant is that it's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong."*

Richard Dennis:

- *"…all the profits are in 5% of the trades."*

Jerry Parker:

- *"60% of my trades are losses."*

Larry Hite:

- *"Becoming wealthy and successful isn't simply about being right all the time. It's about how much you win when you are right as well as how much you lose when you are wrong."*

Marty Zweig:

- *"You can be right on individual stocks as little as 30 percent of the time and still do well if you can get out when the getting is good."*

Paul Tudor Jones

- *"It's very hard to find a pure fundamentalist who's also a very successful macro trader because it is so hard to have a hit rate north of 50 percent."*

Bernard Baruch:

- *"Even being right three or four times out of ten should yield a person a fortune if he has the sense to cut his losses quickly..."*

Using the wisdom above, for any given ten trades, odds are you're going to take a small loss on six or seven. That means you only win on three or four.

If the outcome of each trade was equal, having a higher losing percentage would be detrimental to profitability:

$$(7*-1) + (3*1) = -4.$$

However, if the size of the 3 winners was 3x the size of the losers, then we become net profitable:

$$(7*-1) + (3*3) = +2.$$

Short of changing bet size, which we will get to later, the only way to make your winners larger than your losers would be to hold them for larger moves which usually means longer holding periods. Per the math above, the winners would have to move more than the losers to be net profitable. In short, ride the winners. Let's hear from our panel of pros:

Bernard Baruch:

- *"I let my profits run...my profits were...the largest sum of money I had made up to that time in any single operation."*

Jesse Livermore:

- *"It was never my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight!"*
- *"They say you never grow poor taking profits. No, you don't. But neither do you grow rich taking a four-point profit in a bull market."*
- *"You know you are right because if you were not, you would have no profit at all. Let it ride and ride along with it."*
- *"Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money. It is literally true that millions come easier to a trader after he knows how to trade than hundreds did in the days of his ignorance."*

Humphrey Neill:

- *"The only position I do not wish to lose is the position in a stock which shows me a profit."*
- *"...curb your natural impulses to jump in and out of trades..."*
- *"...when you are right, let your profits run. By this method you do not need many profits to offset several losses."*

Gerald Loeb:

- *"The program must be aimed at obtaining a sufficient profit to offset the average losses sustained in all investment."*

- *"If one's security investments are managed efficiently, small relative percentage investments will bring large returns..."*

The only way Loeb's advice works is if those small investments move a lot.

Nicolas Darvas:

- *"I would be a fool to sell a stock as long as it keeps advancing."*
- *"I should rather hold on to one rising stock for a longer period than juggle with a dozen stocks for a short period at a time."*
- *"...there are no such animals as good or bad stocks. There are only rising and falling stocks - and I should hold the rising ones and sell those that fall."*
- *"...my most difficult problem was to discipline myself not to sell a rising stock too quickly. I always sold too quickly because I am a coward...I decided that since I could not train myself not to get scared every time, it was better to adopt another method. This was to hold on to a rising stock but, at the same time, keep raising my stop-loss order parallel with its rise."*

Richard Dennis:

- *"Anytime the market goes up a reasonable amount...after you've put on a position, it's probably worth adding to that position."*

Bill Eckhardt:

- *"Perhaps the most fundamental principle of successful trading: Cut your losses short and let your profits run."*

Jerry Parker:

- *"I see what's really generating profits. It's just hanging on to these [winning] trades and not doing something dumb and getting out. That's what's going to take us home and make us successful."*

- *"Never predict how far a market can go."*

Larry Hite:

- *"When something is going well, continue."*
- *"...cut your losses quickly and stay with your winners. This is what makes you money."*
- *"...seek out rising trends, then ride them for as long as they continue."*
- *"Letting your winners run means you don't need to sell until your stop-loss tells you to. Enjoy the ride."*

Trend Followers:

As with the prior sections, if you investigate the trend followers, you will see they advocate riding winners in a big way.

Amos Hostetter:

- *"All major trends take a long time to work themselves out."*
- *"There are times when the best approach is to just sit and do nothing, letting the power of the underlying trend work for you while others argue about the day-to-day news."*
- *"There must always be a good reason before you can permit yourself to close out a profit."*
- *"Do you think that the move will be a substantial one?" - A question from Hostetter's Trade Checklist. If the answer was no, he wouldn't trade.*

Ed Seykota:

- *"The idea is to control initial entry risk...profits take care of themselves."*
- *"Ride winners"*

Michael Marcus:

- *"Perhaps the most important rule is to hold on to your winners and cut your losers. Both are equally important."*
- *"If you don't stay with your winners, you are not going to be able to pay for the losers."*

Bruce Kovner:

- *"[Michael Marcus] also taught me one other thing that is absolutely critical: You have to be willing to make mistakes regularly; there is nothing wrong with it. Michael taught me about making your best judgement, being wrong, making your next best judgement, being wrong, making your third best judgement, and then doubling your money."*

Kovner's comment doesn't make totally explicit the method he is suggesting, but there are three possibilities. One, Kovner substantially increased his bet size on his third judgement, allowing him to make back the losers. Two, Kovner rode the winner resulting in a doubling of his money. Three, some combination of one and two. Given what Kovner has to say on overtrading later, I find it hard to believe he substantially increased his bet size on his third best judgement, leaving me to believe he rode the winner.

George Soros:

- *"[Prior to the early 1980s] I had insisted on knowing far too much about every situation before I made an investment, and often I ended up selling that investment far too soon because I thought that it was not as sound as it ought to be."*
- *"If the stock goes up you buy more. You don't care how big the position gets as part of your portfolio. If you get it right, then build [the position]." - Allan Raphael (Soros Lieutenant)*

Let us digress for a moment. Soros is generally considered a fundamental macro trader, but my contention is that he is more of a trend follower driven by the principles than anything. I will elaborate. Soros said the following, which is remarkably similar to Livermore's comment about the "non-essentials" earlier (i.e. anything but price).

- *"...I don't like working. I do the absolute minimum that is necessary to reach a decision. There are people who love working. They amass an inordinate amount of information, much more than is necessary to reach a conclusion. And they become attached to certain investments because they know them intimately. I am different. I concentrate on the essentials."*

Further, Soros said:

- *"Generally, we followed the principle of investing first and investigating later."*

And, per above, we have him telling us knowing too much about an investment caused him to exit far too soon.

If someone told me the secret to his success was cutting losses, that he believed trends were the rule not the exception in markets, admitted he did not want to focus on non-essentials (echoing Livermore's comments above on the essentials being prices), wasn't concerned with knowing his investments intimately, and invested before he investigated (did research), this would be a clear statement that he is/was a trend follower and trusted price above all else. What else can be inferred?

Soros said as much earlier in identifying himself as being a trend follower most of the time, but I felt adding depth here was worthwhile since the combined commentary hammers home my view that Soros was primarily driven by the principles.

Stan Druckenmiller:

- *"Normally...I'll go in with, say, a third of a position and then wait for the price confirmation. And when I get that, when I get a technical signal, I go."*

- *"...you sort of put some positions on; and then when the thesis starts to evolve, and people get on and you see the momentum start to change in your favor, then you really go for it. You pile into the trade."*

As in other comments, Druckenmiller makes us work for his meaning. However, we have already established that he would get out of things when they didn't work or he changed his mind. And here we have him telling us he adds to his position when the price confirmed his thesis. The only way the price could confirm would be to move in the direction of his position. If that isn't riding a winner, what is?

Paul Tudor Jones:

- *"If I have positions going against me, I get right out; if they are going for me, I keep them."*

Martin Zweig:

- *"According to my rulebook, the only consistent way to make money in the markets is to cut losses and run with profits."*
- *"Big money is made in the stock market by being on the right side of the major moves."*
- "*I'm satisfied if I can predict a market trend, get in tune with it, and stay with that trend as long as it lasts."*

William O'Neil:

- *"...small losses will be offset by much larger profits from your big winners."*

Mark Minervini:

- *"...your losses obviously need to be contained on average to a level lower than that of your gains."*
- *"You must make more on your winners than you lose on your losers..."*

Let's pause and recap what we've learned:

1. Cut losses quickly and keep them small.
2. Respect the price action of the market; follow price trends.
3. Your less frequent winners must be big enough to pay for your more frequent losers, ride winners.

PREDICTION

You may have noticed that the word "prediction" is absent from the principles I listed above. In my research, I didn't find that successful prediction had much to do with success in trading. In fact, to the extent I found much about predicting markets, it was the opposite of what you'd probably expect.

Martin Zweig tells us:

- *"I've found that investors who rely on crystal balls frequently wind up with crushed glass."*

George Soros says:

- *"My financial success stands in stark contrast with my ability to forecast events...in predicting financial markets, my record is less than impressive."*

Larry Hite says:

- *"...my investing approach is never based on predicting the future. (Hint: Nobody can predict the future!)...When you start believing you have remarkable predicting powers, you get into trouble every single time...Never, ever forget that no one can predict the future."*

Ultimately, my conclusion is that the three principles already examined – cutting losers, respecting price action, and riding winners – are primarily responsible for the success of the legends. The legends might argue with me to kingdom come on this point, citing their favorite metrics. But, as you will see shortly, nothing else is as consistent over time as cutting losers, respecting and following prices, and riding winners.

Incidentally, there was a trader/author named Bruce Babcock who did a lot of research, similar to what I am doing here, on futures traders. Here are some excerpts from Babcock's concluding summary in his 1996 book *The Cardinal Principles of Trading:*

- *"You can reduce successful trading to four key principles: (1) Trade with the trend, (2) cut losses short, (3) let profits run, and (4) manage risk. Any successful trading approach will necessarily incorporate each of these principles in some way."*
- *"Note that learning to predict the markets is not one of the principles...I have news for you. The markets are not predictable."*

In addition to the principles above, there are a handful of other things that were repeated often enough that they need to be considered in the context of any trading strategy. The first is managing emotions.

MANAGING EMOTIONS

You might look at the three principles above and think this sounds pretty easy, it isn't rocket science after all. However, what you are forgetting is human nature.

Human nature makes us incredibly averse to taking a loss. Odds are you have heard something about this. The modern-day experts on loss aversion are famed behavioral economists Daniel Kahneman and Amos Tversky (K&T).

K&T started a collaboration in the late 1960s which produced a lot of research on the cognitive biases inherent in human beings. The short version is the pain of losing is much greater than the pleasure of winning - people hate taking a loss. This leads us to be hard wired to want to cut winners and ride losers. So, while cutting losses sounds easy on paper, it isn't so easy in reality. Our own human nature makes it hard.

While K&T are the modern-day heroes of cognitive psychology as it relates to markets, their concepts are hardly new. In his book, *Tape Reading & Market Tactics,* Humphrey Neill referenced a 1930 book titled *Why You Win Or Lose: The Psychology of Speculation*, by Fred C. Kelly.

On Humphrey's advice, I decided to take a look at Kelly's book. I was glad I did. Kelly was something of a renaissance man in his time, publishing a multitude of books on far ranging subjects. Let's see what Kelly has to say:

- *"Every natural human impulse seems to be a foe to success in stocks. And that is why success is so difficult."*
- *"I learned that men win or lose not so much because of economic conditions as because of human psychology. Certain mental traits that we nearly all have are barriers to success."*
- *"Vanity, one's own personal vanity, is probably the greatest single enemy to stock market success. It is vanity that leads us to take small profits but large losses. Even a fraction of a point profit is all right, because, small as it is, you have nevertheless beaten the game, and this is a sop to vanity. But a fractional loss hurts your pride and instead of accepting this small loss after a stock begins to look sour, you say you'll wait until you get out even."*

- *"While you are waiting to get out even, the price sinks to a point where the facts are too painful to face..."*
- *"...the tendency is to take small profits but let losses run."*
- *"Because of vanity, men hate to be compelled to do anything. We hate to concede that even a panic can make us sell stocks that we hadn't planned to sell...It is vanity that makes men sell good stocks and keep poor ones in time of distress. They won't sell the poor ones, because these represent a loss...It is vanity which makes nine people out of ten, in a declining market, persistently buy more of the same identical stock in which they took a licking."*
- *"Instead of quitting a stock which seems to prefer to go down and climbing aboard one which shows resistance to the decline, they say to themselves: 'I'll teach that stock a thing or two; it needn't think it can throw me for a loss.' The weaker the stock is, the more they buy as it slides downward. They return to kiss the hand that struck them."*
- *"Next to vanity, I suppose the worst foe to good judgment that a person in the market must guard against, is old Uncle Greed...Few can sit back and wait...Greed is an enemy of patience."*
- *"The few who contrive to take more out of the stock market than they put into it do so by going contrary to what would be generally accepted as logic."*
- *"...if you sell the ones in which you have a profit and keep the others, when the tardy ones advance you will then have a profit on all. The only trouble with this reasoning is that, though logical, it is often wrong."*
- *"The stocks which advanced in price probably did so because of their merit, because of expanding business in the corporation they represent. They are therefore the ones most likely to keep on advancing. Likewise, those that stood still did so because they were already priced high enough. Especially in a time of forced selling to meet margin calls, you are naturally inclined to sell gilt- edged stocks and keep poor ones. You say to yourself: 'I'll sell those that will bring me more than I paid for them and hold others until they, too, show a profit.' Because of your faculty for reaching logical conclusions, you have sold the stocks most capable of giving you profits, or of pulling you out of the hole, and have kept those more likely to go lower in price than upward. In the end, you discover that you are nursing a bunch of chronic invalids."*

Kelly's main point is that it is human nature that is primarily to blame for trading failures.

Having heard Kelly's opinion, let's hear from our panel:

- *"Above all else...the stock market is people. It is people trying to read the future...What drives the prices of stocks up or down is not impersonal economic forces or changing events but the human reactions to these happenings...The main obstacle lies in disentangling ourselves from our own emotions." - Bernard Baruch*
- *"...human frailty which we all possess in some degree...becomes the investor's and speculators greatest enemy and will eventually, if not safeguarded, bring about his downfall..." - Jesse Livermore*
- *"Pride of opinion accounts for as many losses in the market as any other human factor I can think of...Many traders, because of losses from previous trades in a certain stock, feel that the stock 'owes them something'. They take gambling risks in order to 'get even': I should say, in order to satisfy their pride or vanity..." - Humphrey Neill*
- *"Human likes and dislikes will wreck any investment program." - Gerald Loeb*
- *"Now I know that it [loss] was caused by egotism leading to vanity leading to overconfidence, which in turn led to disaster. It was not the market that beat me. It was my own reasoning instincts and uncontrolled emotions." - Nicolas Darvas*
- *"To follow good trading principles is tough. You're swimming upstream against human nature...Most people's emotions and intuitions will get them in trouble and I don't think I'm any exception. I'm not one of the one in a hundred people who can just do it intuitively. I don't believe it and I try to teach just the exact opposite." - Richard Dennis*
- *"If I wasn't trading systematic, my emotions would have an impact...Random emotional trades, no good." - Jerry Parker*
- *"Your real trading system includes your math and your own willingness to experience your feelings about following your math...Willingness to experience your feelings about your system without acting on them is essential to system trading...If you want to trade consistently, without the swings in confidence, then you have to learn to accept, even celebrate, the feeling of uncertainty." - Ed Seykota*

- "Why do you think you did so poorly on your investments [outside trading]? *I would do everything emotionally." - Michael Marcus (Question from Jack Schwager)*
- *"...when something happens to disturb my emotional equilibrium...I close out all positions related to that event." - Bruce Kovner*
- *"...around March [2000] I could feel it coming. I just - I had to play. I couldn't help myself. And three times during the same week I pick up a - don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought $6 billion worth of tech stocks, and in six weeks I had left Soros and I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself...I think [an ideal] characteristic [for a trader/investor] would be being able to control your emotions." - Stan Druckenmiller*
- *"I try to avoid any emotional attachment to a market...It is important because it gives you a wide open intellectual horizon to figure out what is really happening." - Paul Tudor Jones*
- *"Sam's fatal flaw...is that he had a preconceived idea of where the market would go...when conditions changed...Sam refused to accept the new evidence...Instead, Sam began to search for shreds of evidence to support his bearish case. This is a very common trait of stock market investors. Psychologists would call it 'selective perception.' One sees only what one wants to see. Unfortunately, in the stock market, there is always some bearish evidence and some bullish evidence. You never have difficulties unearthing clues to back your viewpoint...I could argue that a year after I had turned bullish the market was higher. I could argue that I was not wrong, just 'early'. I could stubbornly insist that I was right and the market was wrong...The fact is, I was just plain wrong, I knew deep in my bones I was wrong, but my ego got the best of me..." - Martin Zweig*
- *"Most investors could get out cheaply, but because they are human, their emotions take over. You don't want to take a loss. So you wait and you hope, until your loss gets so large it costs you dearly. This is by far the greatest mistake nearly all investors make..." - William O'Neil*
- *"The road to success in the stock market is not a system or a strategy; it's within you, and it will be realized only to the extent that you are able to control and*

> *direct your emotions as you encounter challenges, of which I assure you there will be many." - Mark Minervini*

Clearly managing emotions is a big part of success in trading. I won't go into detail here but Cognitive Behavior Therapy (CBT) is, in my opinion, a great potential way to help manage emotions. If you're interested, read *When Panic Attacks* by David Burns. Let's move on to the next principle: avoiding overtrading.

OVERTRADING

The next most frequent principle is you should not overtrade. Overtrading does not have a precise definition, but the legend's quotes should help to clarify the meaning. In general, the message is that you should not risk too much on any one trade.

Before hearing from our legends, keep in mind they didn't always practice what they preach. It would have been virtually impossible for someone like Livermore to consistently wipe out if he hadn't taken too much risk. Similarly, if you do the math (literally), you see many of the staggering track records experienced by the legends would not have been possible without an inordinate amount of risk and some good (lucky) timing.

This disconnect between practicing and preaching likely stems from either:

1. Youthful ignorance and subsequent hard lessons learned (hence their subsequent preaching risk control)
2. Human emotion overcoming better judgement (see the previous section).

This realization creates somewhat of a contradiction. Do excessive risk taking and luck contribute to the best track records? Probably…along with other factors like tax loopholes and minimal competition. However, survival over a long horizon requires not overtrading.

Another quick point, most of the world thinks of "risk" in terms of the percentage of a portfolio. So, traditionally, someone will risk 5% of their portfolio. For a given $100k, they will buy 5% or $5k worth of a stock. Thus, their risk is 5%.

Our legends tend to do it differently. They pick a point they will enter ($100) and a point they will exit if wrong ($90 aka the stop loss). The distance between entry and the stop loss is their risk ($90 - $100 = -$10 per share). For the same $100k portfolio seeking to risk 1% of the account per trade, the risk would be $100k*1% = $1000. Our legends would then determine how many shares to buy by dividing the risk "budget" ($1000) by the risk per share ($10). Here, that would be 100 shares. If the stock falls to their stop point, they lose $10 100x or $1000 (the risk budget). Ed Seykota talks more about this below.

The trader approach outlined above tends to rely on margin to build diversified portfolios or forces a few concentrated positions. With the approach above, you usually run out of capital before you build a large stock portfolio and, unlike futures contracts which inherently offer low margin at minimal costs, buying stocks on margin can get costly.

If this doesn't make sense, get a calculator or spreadsheet and see how many stocks you can buy using the method above with a $100k account with a 1% risk budget and a 10% from entry stop before you've used the whole $100k (remember, despite using the trader approach, 100 shares of a $100 stock is still $10k or 10% of your $100k account – spoiler: you could only buy 10 stocks before you run out of money).

Let's hear from our panel.

<u>Bernard Baruch:</u>

- *"There are two principal mistakes that nearly all amateurs in the stock market make...The second mistake is to trade beyond one's financial resources, to try to run up a fortune on a shoestring."*
- *"I would buy stocks or bonds to the limit of my resources. Some market fluctuation would come along and swamp me. Only after this happened again and again did I learn the lesson of not overplaying my hand and of always holding back some part of my capital as a reserve. Had I learned this earlier I would have saved myself many a heartache in going broke again and again."*
- *"After my youthful reverses were behind me, I tried never to go into any speculation over my depth."*

<u>Jesse Livermore:</u>

- *"One major mistake of all speculators is the urge to enrich themselves in too short a time...Such speculators are never satisfied. They continue to shoot the works until somewhere a cog slips, something happens - something drastic, unforeseen, and devastating. At length comes that final margin call from the broker, the call that cannot be met, and this type of plunger goes out like a lamp."*

- *"...if the speculator were smart enough to know at just which time he should over-trade, the practice would be justified. He may know at times when he could or should over-trade. But once acquiring the habit, very few speculators are smart enough to stop...They never think of the day when they will be wrong. But that day arrives. The easy money takes a wing, and another speculator is broke."*
- *"...risk only a limited amount of capital on any one venture."*

These quotes come from later in Livermore's life. Presumably, having wiped out several times prior to making these comments, he was speaking from experience.

Humphrey Neill:

- *"Do not plunge or become over-extended."*
- *"...margin and capital worries warp your judgement and hamper your trading skill."*
- *"...never overtrade, maintain a margin of at least 50 percent."*

Gerald Loeb:

- *"I suggest the size of commitments in one sense be kept small - that is, the relationship of funds employed to total capital."*
- *"...the possibility of a 'margin call' should never even remotely develop in a well run account."*
- *"If one's security investments are managed efficiently...the necessity for over-speculation with its many handicaps will not occur."*
- *"...a given situation might at times call for borrowing, but I feel rather sure that I would always counsel a good deal smaller debit than the popular margin percentages at the time."*

Bill Eckhardt:

- *"You shouldn't plan to risk more than 2 percent on a trade."*

Jerry Parker:

- *"Your leverage is a huge choice. Trade small. When you lose, trade even smaller."*

Larry Hite:

- *"...don't lose all your chips, because then you can't bet...my thinking, my system, is based on controlling my risk to the downside so that I never lose all of my chips...you can't lose your shirt if you don't bet your shirt."*

Amos Hostetter:

- *"Sound money management is crucial to successful trading."*
- *"...it was quite a rare occurrence for [Hostetter] to risk as much as 10 percent of his equity on any single trading idea."*

Quick note, Hostetter is the only person I have read about who risked above 5% a trade. See what Seykota, Marcus, and Kovner have to say below.

Ed Seykota:

- *"Heat, as I use it, is the measure of equity-normal trade risk. For example, if you trade a $1,000,000 account with 1% heat, your risk budget for your next trade is $10,000. If each contract has a risk-to-stop of $2000, you enter five contracts."*
- *"...many seasoned professionals consider risking 1/2% [heat] to be lively, 1% to be aggressive and 5% to be maniacal."*
- *"Rules of Thumb: Speculate with less than 10% of your liquid net worth. Risk less than 1 % [heat] of your spec account on a trade."*
- *"These days, one futures contract can move several thousand dollars per day - so with diversification into, say a dozen instruments, you might normally experience daily fluctuations of 5-10 k, sometimes much more. If you want to keep your risk*

per trade at about 1/2 percent, then, setting 1/2 % to $5000, you get 100% = $1,000,000."

- *"If you trade a $100,000 account, you might have to experience 5% entry risk."*
- *"...many seasoned professionals consider risking...5% to be maniacal..."*

Michael Marcus:

- *"...bet less than 5 percent of your money on any one idea. That way you can be wrong more than twenty times; it will take you a long time to lose your money. I would emphasize the 5 percent applies to one idea. If you take a long position in two different related grain markets, that is still one idea."*

Bruce Kovner:

- *"Undertrade, undertrade, undertrade..."*
- *"My experience with novice traders is that they trade three to five times too big. They are taking 5 to 10 percent risks on a trade when they should be taking 1 to 2 percent risks."*

George Soros:

Soros is somewhat the exception to the rule here. He advocated going for the jugular when the stars aligned. However, he still managed his risk. Depending on the source, specifics vary, but Soros was said to have only 4% of his portfolio at risk with the famed British Pound bet.

Stan Druckenmiller:

- *"...I learned that you could be right on a market and still end up losing if you use excessive leverage."*

Paul Tudor Jones:

- *"Mr. Stupid, why risk everything on one trade? Why not make your life a pursuit of happiness rather than pain?"*
- *"...never overtrade."*

Martin Zweig:

- *"If you have $25,000, you probably shouldn't buy more than $25,000 worth of stock, if that. The average guy comes in, uses margin...he has no real staying power."*
- *"The interest [on margin loans in stocks] isn't exactly chopped liver."*
- *"[When using margin in stocks] You are extended and leveraged and tempted to take small profits, rather than letting profits run."*
- *"I went totally on margin...I was right on the stock but, with almost all my money in this one stock, had almost no staying power...[the stock] did pretty much what I thought it would do...Had I stayed with it, I would have made 50 points and earned $100,000 on my equity of only $20,000, But that's only a fantasy...I owned so much of it that I couldn't stand the pressure...I always think back to [this investment] when I think about margin. I just don't feel good about using it."*

William O'Neil:

- *"...Costly Common Mistakes Investors Make...Speculating Too Heavily..."*
- *"If you're invested on margin...you can get seriously hurt."*

Mark Minervini:

- *"When I first started trading and had little money I used margin, but I don't use leverage anymore."*

From this point forward, at times the principles start to become a lot less consistent. In the name of cutting to the chase, I will start deviating a bit from presenting the quotes of each legend instead presenting a more general view.

BET SIZING

An area to explore that is closely related to overtrading is bet sizing or how much to risk per trade. Bet sizing is a topic on which our legends tend to have diametrically opposed views.

Stan Druckenmiller offers us the following:

- *"Soros taught me that when you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig. It takes courage to ride a profit with huge leverage."*

Conversely, Jerry Parker tells us:

- *"We size our positions based upon the ATR [Average True Range] and we normalize our losses, give each market the same amount of room and make the losses the same dollar amount..."*

Keep in mind, per the prior section, that virtually all of our legends advocate not betting too much. This might seem a bit contradictory relative to Druckenmiller's comments here. I'd have to defer to him on the technical definition of what is acceptable versus unacceptable "huge leverage" since, according to his comments, there is presumably a line.

Finally, using the trader risk model outlined earlier, the modern consensus seems to be to risk 0.50% to 1% per trade. Much more than that will eventually produce drawdowns that result in high emotion.

TRADE DURATION

Another thing that is fairly consistent is the choice of trading timeframe. Almost none of our greats advocated day trading or were playing for small moves. You can essentially infer this from some of the comments in the previous sections, but I will add more evidence here.

As a quick caveat, at times, large moves can happen quickly which might override a specific holding timeframe. But, as a general rule, it takes time for markets to move large percentages. And our legends are playing for the bigger moves. Ed Seykota sums up the concerns with short-term trading well.

Ed Seykota:

- *"Price action tends to be fractal; the same patterns show up at all degrees of zooming in and out on the charts. Transaction costs, however stay the same. So shorter term strategies suffer a higher ratio of transaction costs to gross returns."*
- *"The shorter the term, the smaller the move. So profit potential decreases with trading frequency. Meanwhile, transaction costs stay the same. To compensate for profit roll-off, short-term traders have to be very good guessers. To improve guessing skills, you can practice dealing cards from a standard deck, one at a time. When you become very good at it you might be able to make money with short term trading."*
- *"I have not seen any simulation studies showing profitable regions of operation for High Frequency Trend Trading since the transaction costs and slippage become prohibitive."*
- *"The problem with Day-Trading is in the execution. I have an open challenge to see a 1-year back-test of a day-trading system that matches actual brokerage statements."*
- *"Scalping, trading against large orders, to provide liquidity, requires skill and experience and close proximity to the action, such as a seat on the floor."* [or a colocated server these days]
- *"Long-term trading has an advantage, in that the transaction costs are small relative to the average move."*

- *"While it's good to use your head to enter and exit trades, you make the big money using your other end...sitting tight on winning positions."*
- *"If you want big profits, you want big trends, and to trade long-term."*
- *"You can get some experience with trends by trying out different trend definitions in the context of a trading system, and then back testing to determine theoretical profitability. This exercise generally dissuades people from employing short-term systems."*

And here are some thoughts on holding periods from a handful of other greats.

Jesse Livermore:

- *"...money cannot consistently be made trading every day or every week."*
- *"The speculator who insists on trying to profit from the daily minor movements will never be in a position to take advantage of the next important change marketwise when it occurs."*
- *"...speculators who feel they must trade day in and day out, are laying the foundation of your next venture. You will reap the benefits from their mistakes."*
- *"'Rome was not built in a day,' and no real movement of important ends in one day or in one week."*

Humphrey Neill:

- *"...anyone who attempts to catch the hourly, or even daily, fluctuations of stock prices is entering upon a risky, foolhardy enterprise."*
- *"There are some traders who have made, and are making, money from these so-called scalping operations; but I have never met one who was successful for long."*
- *"It is my opinion that there is little use in trying to make money consistently by trading in and out of stocks hourly, or daily."*
- *"The longer the trend, the more opportunity we have to be right. This is why I urge always that trading be confined to the intermediate trends."*

<u>Nicolas Darvas</u>

The examples in Darvas' book *How I Made $2,000,000 in the Stock Market* show the stocks he bought rising substantial amounts. He was not trading for small moves.

<u>Jerry Parker:</u>

- *"...everyone should desire to trade as short-term as possible, as long as you're still making money..."*
- *"I don't trade shorter-term than I do because I can't find anything that works..."*

<u>Amos Hostetter:</u>

- *"All major trends take a long time to work themselves out."*
- *"There are times when the best approach is to just sit and do nothing, letting the power of the underlying trend work for you while others argue about the day-to-day news."*
- *"Do you think that the move will be a substantial one?" - A question from Hostetter's Trade Checklist. If the answer was no, he wouldn't trade.*

<u>Martin Zweig:</u>

- *"Big money in the stock market is made being on the right side of the major moves."*

<u>William O'Neil:</u>

If you look at the examples in O'Neil's *How to Make Money in Stocks,* they focus on stocks with, "…*spectacular price increases."* Most of the percentage returns he shows are over 100% meaning a stock went from 50 to 100 (or more). Clearly, he is not playing for small moves and, per the caveat earlier, large moves in short timeframes are rare.

Mark Minervini:

Similar to O'Neil, in his book *Trade Like A Stock Market Wizard,* Minervini refers to "superperformance" stocks experiencing, "*...phenomenal price surges...".* He also offered the following on Twitter:

- *"Day traders and very short term guys love this type of high volatility market. I avoid these periods. This is what I call a 'hard penny' environment. Why fight for pennies when you can simply wait for easy dollars?"*

Overall, I didn't find evidence that any of the greats consistently day traded. Day trading also typically requires a good deal of leverage to turn small average wins into meaningful dollars. We know how the pros feel about high leverage. My guess is the panel would frown on day trading for that reason as well.

TIPS & INSIDE INFORMATION

Another principle, amongst the stock traders, was to avoid tips and inside information like the plague. Let's see:

- *"The longer I operated in Wall Street the more distrustful I became of tips and 'inside' information of every kind...Beware...anyone-bringing gifts of 'inside' information or 'tips.'" - Bernard Baruch*
- *"I urge you to keep a little notebook with you...On the first page I suggest you write - no, better yet print it in ink: 'BEWARE OF INSIDE INFORMATION...ALL INSIDE INFORMATION.'" - Jesse Livermore [Uppercase in the original.]*
- *"Tips are dangerous...check your tips on the tape." - Humphrey Neill*
- *"Most rumors and tips you hear simply aren't true. Even if they are true, in many cases the stock concerned will ironically go down, not up as you assume." - William O'Neil*

The greats are not as consistent here as they are on other topics, but there is enough evidence that I felt it worth including.

FUNDAMENTALS

Fundamentals are an area where our legends often have polar-opposite views. Let's look at the ends of the spectrum by taking a look at some quotes:

On one end of the spectrum, we have several legends who use fundamentals:

- *"I made a resolution never again to take an important risk in anything I did not know about...Before you buy a security, find out everything you can about the company..." - Bernard Baruch*
- *"I use technical analysis a great deal...but I can't hold a position unless I understand why the market should move." - Bruce Kovner*

And, on the other end:

- *"Fundamental Analysis is basically trying to guess right...Fundamental analysis assumes you can understand the intention of an entire system from information you can gather at one node. It also assumes you can arrive at your conclusion before the market discounts it...A need to know everything before you act can interfere with trading...You might notice that news often appears to justify a price move after a large part of the move is already on the chart...Analysis and figuring it all out are optional, often counterproductive [to trading]...One good cure for the tendency to believe fundamental predictions: save the prediction and re-play it in about 10 years." - Ed Seykota*
- *"I could trade without knowing the name of the market." - Richard Dennis*
- *"...quit trying to be an expert...force yourself to look at price only..." - Jerry Parker*

We also have some in the middle:

- *"Rather than limiting yourself, you must consider both fundamental information...and the technical side..." - William O'Neil*

Both of the extreme camps, and the middle ground guys, have been successful. So, who is right? No one. Or, maybe everyone depending how you look at it.

To me, the takeaway is that there have been successful traders who have paid attention to fundamentals, and successful traders who have not. So fundamentals are certainly not a requirement to obtain trading success based on the outcomes of the pros.

DIVERSIFICATION

Like fundamentals, diversification is another topic with highly dichotomous views. Let's take a look:

In this corner, we have the diversified:

- *"...follow prices, follow trend, and expand your portfolio to hundreds of markets..." - Jerry Parker*
- *"You might consider postponing trading until you can afford to implement diversification." - Ed Seykota*

And, in the other corner, we have the undiversified:

- *"I strongly believe the only way to make long-term returns in our business that are superior is by being a pig. I think diversification and all the stuff they're teaching at business school today is probably the most misguided concept anywhere. And if you look at all the great investors...they tend to [make] very, very concentrated bets. They see something, they bet it, and they bet the ranch on it. And that's kind of the way my philosophy evolved...if you really see it, put all your eggs in one basket and then watch the basket very carefully." - Stan Druckenmiller*
- *"There's no reason to own twenty or more stocks. You simply can't know all you need to know about that many. You'll also dilute your overall results." - William O'Neil*

As with fundamentals, there is a middle ground here too.

To the extent there is a pattern, those using fundamentals typically advocate concentrated portfolios since it is hard to have a view on too many things and they don't want to dilute their fundamental bets.

Non-fundamental types typically focus on lots of small bets and broad diversification. Their view is that the future is unknowable, so trying to research fundamentals is not a worthwhile endeavor. They just respect and follow price action by buying strength or selling weakness, then riding winners and cutting losers.

ENTERING TRADES

Next up is the method used to enter a trade. On this topic too, the greats are not consistent. Let's take a look at some highlights:

- *"Trend followers trade at new highs and at new lows [if going short]." - Ed Seykota*
- *"That is everyone's favorite technique – to buy something strong that retraces. I don't see any justification in the statistics for that. When beans are at $8.00 and go to $9.00, if the choice is to buy them at $9.00 or buy them if they retrace to $8.80, I'd rather buy them at $9.00. They may never retrace to $8.80. Statistics would show that you make more money buying them and not waiting for a retracement." - Richard Dennis*
- *"I have multiple entries and multiple exits [for] different systems...it may look like I'm adding into the trend cause I'm not doing them all at the same time and I'm not going to buy lower prices...so I guess I'm adding into the trend in a predetermined way, systematic, most importantly not based on the profit in the trade from the other entries. So it's the 50 day high then the 60 day high then let's buy some more at the 70 day high...something like that...I don't use those parameters." - Jerry Parker*
- *"I become a buyer as soon as the stock makes a 'new high on its movement, after having had a normal reaction'" - Jesse Livermore*
- *"A period of testing may intervene when prices suffer a setback. If the bias and trend survive the testing, both emerge stronger than ever..." - George Soros*
- *"I've never made a buy at a low that I didn't just feel terrible and scared to death making it. It's easy to sell at the bottom. When things are going up, it's easy to buy them. When things are going down, it's hard to buy them...Normally...I'll go in with, say, a third of a position and then wait for the price confirmation. And when I get that, when I get a technical signal, I go...you sort of put some positions on; and then when the thesis starts to evolve, and people get on and you see the momentum start to change in your favor, then you really go for it. You pile into the trade." - Stan Druckenmiller*

- *"The best buying spots are short-term pullbacks of 5% to 10% from a high, provided that the small downmove does not violate a recent prior low." - Martin Zweig*
- *"I was constantly watching for an upward thrust...if this occurred I bought the stock." - Nicolas Darvas*
- *"The optimal buy point of any stock is its 'pivot point,' the point at the end of a basing area when the stock price is breaking out into new high ground." - William O'Neil*
- *"Find out whether the buyer is stronger than the seller, or the opposite, and act accordingly. Volume will give you the answer." - Humphrey Neill*
- *"I execute a trade only at the point of alignment across the spectrum with regard to company fundamentals, stock price, and volume activity as well as overall market conditions." - Mark Minervini*

Clearly there are differences in the entry points preferred by the various greats. To the extent there is a most consistent approach here, it is likely buying new highs or selling new lows (if going short). But keep in mind the timeframe means a lot; a 50-day high might be near a 200-day low.

Reading the quotes above, we see the possibilities are really endless. With that in mind, let's hear another great analogy-laden response from Ed Seykota to an inquiry for the best trading system:

- *"The best car for you might not be the best car for me. I have kids and live in snowy mountains so I like a station wagon with all-wheel drive. If you can define a Bliss Function that includes all the things you like about a system then you can find the best system, for you."*

Having explored entry methods used by the greats, we should examine exits.

EXITING TRADES

The greats' process of exiting a trade almost always comes via stop losses. The methods of determining their stop out points are quite varied. Let's see what they advise:

- *"Generally I set my stops 10% to 20% below my purchase price. The exact level depends on my own analysis of the stock's pattern and the 'feel' I've gained from two dozen years of experience in the market...the first use of the stop is to protect against losses...The second use of the stop is to lock in profits...The idea is to let your profits ride as the stock keeps rallying. As it continues to climb, you keep raising what is called the 'trailing stop'." - Martin Zweig*
- *"The position size on a trade is determined by the stop, and the stop is determined on a technical basis. For example, if the market is in the midst of a trading range, it makes no sense to put your stop within that range, since you are likely to be taken out. I always place my stop beyond some technical barrier...the point about a technical barrier...is that the market shouldn't go there if you are right." - Bruce Kovner*
- *"I don't try to get out right at the top. But I'm not averse to making a stab at a counter technical consolidation if the position is right. I'm not paying attention to it - it has to sort of come up and bite me. That happened last summer [1983] in beans. That was a classic total correction. But that doesn't happen as much as the other kind where I just wait until it goes against me a certain amount before I get out." - Richard Dennis*
- *"I think [stop determination is] part of the backtest and part of choosing different parameters you'll get seemingly different answers but you can trade 50 markets or 40 markets or 100 markets, thinking you can even risk 50bps in every energy trade...oh I'm only risking 50bps...no you're risking a lot more than 50...so it depends on your backtest and your stop loss...how close is your stop loss...if your stop loss is 1 ATR away and you're risking 25bps you're going to have a lot of losses and a low win percentage...all these things play into each other..." - Jerry Parker*

- *"Part of back-testing is to determine position sizing and risk management strategies that fit within your drawdown tolerance envelope...All [Ed's trading systems] use stops and all stops trail the price." - Ed Seykota*
- *"...I always liquidate half of my position below the new highs or lows...I have a mental stop. If it hits that number, I am out no matter what...right now I am down about 6 ½ percent for the month. I have a 3 ½ percent stop on my equity for the rest of the month. I want to make sure I never have a double-digit loss in any month." - Paul Tudor Jones*
- *"...my most difficult problem was to discipline myself not to sell a rising stock too quickly. I always sold too quickly because I am a coward...I decided that since I could not train myself not to get scared every time, it was better to adopt another method. This was to hold on to a rising stock but, at the same time, keep raising my stop-loss order parallel with its rise." - Nicolas Darvas*
- *"Always cut your losses at 8% below your purchase price...If you cut all your losses at 7% or 8% below your purchase price, and then sell just a few of your stocks when you're up 25% to 30%, you can be right once and wrong twice and still not get into trouble." - William O'Neil*
- *"Loss cutting is a function of expected gain. The more accurately you can predict the level of gain and the frequency at which you can expect it to occur, the easier it is to arrive at where you should be cutting your losses. Your maximum stop loss depends both on your batting average (percentage of profitable trades) and on your average profit per trade (expected gain)." - Mark Minervini*

Clearly there is no one right way to set a stop.

CONCLUSION

Let's recap with an eye toward the generalizable. Cognizant there are shades of grey, and knowing nothing works all the time, if we want to align ourselves with the principles of the greats, we definitely want to:

1. Cut losers
2. Respect price action and follow price trends
3. Ride winners
4. Manage emotions
5. Not overtrade

We also know we likely shouldn't day trade and we want to hold trades for larger price moves which typically means longer time periods. And, we should seriously consider avoiding tips or insider information.

Regarding fundamentals, diversification, and bet sizing, there are no certainties, but we seem to have an approximate choice:

1. If we use fundamentals, the lessons of the greats imply we should not overly diversify, and we should make larger individual bets (mindful of overtrading).

2. If we do not use fundamentals, we should vastly diversify, and our bets should all be about the same.

Regarding entering a position, there is no right way but, to the extent there is a consistency to be found, it would be to buy highs and sell lows (when going short). Exiting a position will likely be determined by a stop loss or a trailing stop loss. We know we need a stop loss of some kind, but the method we use to set the stop is subjective, as is whether to trail the stop and how to trail the stop.

In closing, I hope you walk away feeling much more informed. You have a lot to consider in making your personal process better. Keep in mind that no amount of reading substitutes for actual trading experience. In the words of the greats:

- *"I realized I was on my own. I was certain I could learn nothing more from books." - Nicolas Darvas*
- *"I realized that it is one thing to be able to hit a target right in the bull's- eye, but quite another thing to do so if several men are shooting at you." - Fred Kelly*
- *"Neo, sooner or later you're going to realize just as I did that there's a difference between knowing the path and walking the path." - Morpheus character in The Matrix*

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ABOUT ME/THE RESEARCH

As long as I can remember, I have been enormously drawn to trading. I enjoy reading about markets, strategies, systems, philosophies, and traders. I also enjoy aggregating and condensing my research.

Now, as a trader, I use this research to guide my process and stay the course. For example, when I go into a draw down and the seeds of doubt and despair start sprouting, I fortify my resolve with quotes from the best traders of all time. I hope the principles in this book can help to inspire and strengthen you as well.

I enjoy meeting and sharing experiences with other traders. You can reach me at: info@triinv.com or on Twitter: @gfc4.

BIBLIOGRAPHY

<u>Author's Note:</u>

Below I provide pertinent details of the materials referenced throughout my research. My goal here is to provide source materials not to win an award for citation perfection. As such, I ask that you forgive any stylistic imperfections instead focusing on content.

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TRADER COMMENTS

I keep going back to PRINCIPLES OF GREAT TRADERS to remind me of the important core tenets of elite traders. These timeless and indispensable truths continue to motivate me and provide some comfort and confidence to continue to "do the right things" when the markets are tough on my strategy.

– Jerry Parker
Founder and CEO of Chesapeake Capital Corporation.

What drives trading success? Do specific principles exist? What withstands the test of time? In this book George Coyle provides a shortcut to answering these questions by zeroing in on the key take-aways from the world's most successful traders using their own words based on his life-long research. Combined with George's writing skill, the result is relevant and enjoyable reading for existing and prospective traders alike.

– Moritz Seibert
CEO/CIO Munich Re Investment Partners & Co-founder of www.twoquants.com

I consider PRINCIPLES OF GREAT TRADERS amongst a dozen other classics such as Jack Schwager's series of Market Wizards books and Edwin Lefevre's Reminiscences of a Stock Operator. Most investors are fixated on identifying the next big winner, the "what" to buy or sell. Few bother to study the "how" of investing…what are the methods and lessons of the world's great traders over the last 100 years. This book helps fill that void. Well done George!

– Art Holly
Founder and CEO of Breacher Capital

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