CFA Institute Magazine 08 October 2018

Why Self-Sabotage Is the Greatest Trading Risk

Nathan Jaye CFA

A successful career as a trader requires "a tremendous respect for risk," says proprietary trader Peter Brandt.

Key Points

- Traders are their own worst enemies, so guarding against self-sabotage is critical.
- One way to manage self-sabotage is by turning negative character traits into positive behaviors.
- The importance of trade identification is overrated. The most important part of trading is protecting trading capital.

Introduction

In 43 years of commodities trading, Peter Brandt has seen a lot. Brandt, the founder of Factor LLC and author of *Diary of a Professional Commodity Trader: Lessons from 21 Weeks of Real Trading*, has generated a 41.6% average annual return over the past thirty years. In this interview with *CFA Institute Magazine*, Brandt discusses insights into his short and long-term success, managing emotions in a trading process, what classical charting patterns say about the markets, and the rise of crypto Twitter.

What's kept you going and made you successful?

I think about that all the time. I've been a proprietary trader and made my living from the markets. So I'm always thinking about staying power. My perspective is trading a marathon, not a sprint. Except for perhaps the first five or six years of my career, the focus of how I perceive the markets has been: How do I last?

So I think the recipe for longevity is a tremendous respect for risk, number one. I don't view myself as a trader as much as I view myself as a risk manager. My job is to manage my

losses and deal with how I manage losses. After 43 years, I believe that if you can stay in the markets, you're going to have plenty of opportunities to make money. How you manage your down periods is really the recipe for longevity.

I would add another thing. I may be absolutely convinced where a particular market is going to go. But in the final analysis, I don't have a clue. If I approach a market with the idea that I well may be wrong, that changes how I approach the market and how I deal with managing the risk that's involved. I would say these are the main ingredients in my longevity cake.

How do you manage your risk?

If you pay attention to CNBC or Bloomberg or people advertising for research services, If you look at various Twitter streams, the first conclusion you would come to is that success is dependent upon finding the big trade—the successful trade. You would think trade identification is the all-powerful component. Trade identification is the one you've got to get right.

My opinion is that there are four major ingredients to trading. Of the four, trade identification is probably the least important. By far, the most important is keeping capital together. Managing one's trading capital and protecting it from losses. Risk management, in my mind, deals with things related to your capital at risk. The total amount of capital at risk—or as we define it, our total nominal capitalization.

It's an over-arching theme that branches into individual portfolio management, the management of risk of highly correlated positions, the management of risk on individual trades, how trades are managed, and so forth—all are sub-bullet points of overall risk management.

That's where I am always focusing. What is my risk and how am I managing that risk? How am I preventing my exposure to the worst case scenario for asset draw down? If you put up a tent and under the tent is everything that deals with trading, the roof of that tent has to be risk management.

What are your risk management rules?

The big one is that on any given bet, I have a max risk of 80 to 100 basis points. Eight-tenths of 1% of total nominal assets would be risked on a given trade. That's if it is a highly correlated trade. By highly correlated, I think in terms of things like gold and silver, soybeans and soybean meal, bonds and notes, and so forth, the Nasdaq and the S&P. On highly correlated trades, I would limit the maximum risk in my trading to 200 basis points.

As we unpack that package a little, we get into more tactical considerations. While our initial risk on a trade may be 100 basis points or 80 basis points, we want to squeeze that down as quickly as possible. Sometimes even by the end of the first day of a trade. The goal is

that hopefully within two or three days of putting on a trade, we can have a trade where an initial risk of 80 basis points is now a risk of 30 basis points. Or even in some cases break even.

The goal is to enter a trade with initial risk, with the intention to reduce that risk as quickly as the market allows us to do that. Or to get out of the trade—if the trade is going to challenge us and become a loser in two or three days. I take the attitude that part of a trade is direction, part of a trade is timing. If you have one of those wrong, you've got the trade wrong.

Once a trade is in a profit level where we think, “Okay, we have got a good trade,” we try to let that trade run. To not be tempted to take quick profits on the entire position, on a portion of the position.

We have some rules on layering out of a trade, just as we have rules on layering into a trade. It comes back to the adage that we all learned when we entered the exchange-trading business. For myself, it was at the Chicago Board of Trade. You cut losses short and you let winners run. A lot of people pay lip service to it. But I think that most proprietary traders who trade full-time would be able to unpack that box in great detail. Successful proprietary traders have a number of things in common. One of those things is they're all really risk managers. The second is that they pay great homage to the adage of cutting losses short and letting winners run.

You say trading is an “upstream swim against emotions.” Can you elaborate on your experience?

I think if somebody wants to know themselves as a person—if they really want to know the good, the bad, the ugly—just become a trader.

Every core trader will quickly admit that they will self-sabotage if they do not protect themselves from self-sabotage. They are their own worst enemies. Their negative character traits, if allowed to run free and be manifested in emotions that are acted upon, will constantly be self-sabotaging. It's pride, it's greed, it's fear, it's false hope. It's all the things you hear about—and how those various personality traits end up becoming manifest in one's day to day trading activity. Are you impatient? Oh boy, that's not a good one to have.

As a swing trader, if I allow my impatient nature to get the advantage, I will cut my winners short. That goes against the very premise of cutting losses short and letting winners run. I tend to be a person who reacts too quickly sometimes, so I have to guard against that. For me, it's a matter of creating trading rules and then really sticking to those rules.

My personality is obsessive-compulsive. So how do I make obsession a positive trait? Because obsession in trading is not something which will generally yield itself to long-term

profitability. You'll become obsessed with the market. You'll become obsessed with the idea that gold must go up. You'll become obsessed with the idea that stocks need to be shorted.

Well, my obsession has become an obsession for excellence. I am obsessed with the process of trading, with how I do order flow, with knowing my trading metrics. So, it's about taking a personality trait—and instead of letting that personality trait sabotage one's trading—and attempting to use it to one's advantage.

How? Self-observation? Feedback from the markets?

I was lucky that I started at the Chicago Board of Trade. In Chicago, there was a community of traders. You ate lunch with them, you rode the elevator with them, you took the commuter railroad with them, you sat in an office with them. You shared with them and talked your way through the day with them. Being part of a community is important—a community that hopefully is honest with each other. That's a big disadvantage of a lot of traders today. They aren't trading within the framework of a firm, they are trading in an office by themselves. It's a solo journey for way too many traders today.

Another aspect is being transparent with yourself. Can you be completely honest with yourself as you make mistakes, recognize mistakes, and try to trace mistakes back to a basic root. Well, how did that happen? What does that tell me about myself?

The third thing is the markets themselves. The markets will teach you lessons if you let them teach you lessons. Unfortunately for many new traders, the market charges a tuition. To grow as a trader, to evolve as a trader, is really a function of making mistakes. Sometimes over and over again until you learn something about dealing with your mistakes.

Now I'm not talking about trades that lose money. We all have trades that lose money. I'm only right about a trade, let's say, 50 percent of the time. I lose money or break even on a trade 50 percent of the time. That means my default expectation for a trade is that I will lose money. I go into a trade with the assumption that this will not be a profitable trade. That allows me to exercise extra diligence, in terms of risk management.

I can make a stupid trade and have it be a profitable trade. I can also execute my plan with excellence and have my trade lose money. By mistake, I mean the types of things that happen to a trader in the first 3 to 5 years—they use open orders at night in illiquid markets, they place too much size on an order, they overstay their hand. They don't listen to the sentiment of a market.

After a while, we realize we've made the same mistake several times. We need to learn. We need to differentiate that from merely having a losing trade, because you can do everything right and have a losing trade. For me, it's the process of how I analyze markets and how I execute my plan. Do I screw up in the process?

Do you have techniques to manage your emotions?

Absolutely. For me, the big one is: enter orders once a day. Don't pay attention to markets during the day. I tend to be compulsive. If I get glued to the screen, that's the absolute worst thing that I can do—sit in my office and watch these markets change tick by tick as the day progresses. I need to remove myself from that.

I need to have faith in the process upon which I analyze and trade markets. If I start paying too much attention to markets during the day, I lose sight of exactly how I want to trade. I'm in Mountain Time, so I look at the markets that I'm interested in trading on a daily basis, usually after 3 PM, and try to enter my orders by 4 PM. And then at 5:30 the next morning, I'll take a quick review, based on what happened overnight. Do any of the orders that I wanted to place need to be tweaked? And if so, I make the tweak.

The other thing is that my big day is Friday. That's my longest day, my most intensive day. It's on Friday that I determine the ten markets that will be my candidate markets for trading the following week. I'll limit my trading activity to those markets that are set up to be traded and take risks in.

What's your review process?

I subject my performance to a formal advisory board on an annual basis. We go over the performance of my previous years. These are traders—they may not trade like me but they know how I trade. Sometimes they'll get pretty tough with me. They ask me hard questions, and they try to keep my feet to the fire. Am I trading the way that I have told them I am going to trade? They provide me with input—have you looked at this, looked at that? Where are you running into problems? What's happening with your risk management? Did you start cutting back on your risk?

I have developed my trading into a process. What I do in the markets, how I analyze markets, how I analyze my own trading, how I submit myself to self evaluation, how I enter the orders, how I monitor markets for trade set up, is really in a groove. I do the same thing over and over again. Somebody found a speech that I had delivered to the CMT Association back in 1991. I looked at it and I said, "Wow, I really haven't changed much in how I trade." I pretty much trade the same way now that I traded in 1991. That was a reaffirming discovery.

Is your long term success a by-product of short-term methods? Or have you made course corrections?

My course corrections have been tactical, as opposed to overarching corrections. How do I deal with the fact that there are 24-hour markets? How do I deal with the fact that HFTs go on stop raids? My approach to charting has also changed over the years. What I would have considered a trade in 1981, I may not consider a trade today.

I trade with a lot less frequency today that I did in the late 1970s and early 1980s. I would trade 30 to 35 times a month. Now I'm trading a hundred times a year and that number is going down year by year. And that's with the larger universe of trading vehicles.

The number of markets that I monitor today is probably two to three times the number of markets that I monitored back in the early 1980s, and yet I'm only trading perhaps with one third of the frequency.

You once took a 10-year trading sabbatical. Was that important to your career?

It wasn't intended to be a long break. I had started in the business in 1974-75. By 1995, twenty years later, I had been in the 24-hour markets for five years, and it really came to the point where I was just burned out. I needed a break from the markets. I needed to do something that separated me from the markets for a while. My thinking at the time was, "I'll take a year or two off, and I'll pursue some other interests that I have."

I put my money into stock mutual funds and became a passive investor. I was doing things in charitable work and non profits, working with organizations that I was financially supporting, becoming active on the board of directors of worthy organizations, philanthropic type things. I really enjoyed it.

Then there came a time in the mid-2000s where I started getting the itch again. I came to the conviction that I could actually do a lot more for charitable organizations as a donor than as an active advisor. So, in 2006 I again opened a proprietary account, hired a small staff, and relaunched into trading.

Let's talk about charting. What are rectangles, triangles, horns and diamonds?

To a lot of people who are global macro, or take a traditional approach to markets, when they hear the word *charting*, they think voodoo. The reality is that classical charting principles were formulated in 1933 by Richard W. Schabacker (a devotee of Charles Dow), who was the editor of Fortune Magazine. He made the observation that prices, when plotted on a chart, tend to reflect when a market is going through a period of accumulation by strong hands, or distribution by strong hands. What one is seeing in the chart is not directly what one perceives as important fundamentals, but rather a study of the supply and demand factors of the asset itself.

That was the premise upon which Schabacker wrote his book—that a lot can be said about a market based on the chart itself. That the chart was a study of the supply and demand of shares, not necessarily the fundamentals of an industry, or a business, or the overall economy. That's really how classical charting got launched. Depending on the exact geometric dimensions of chart construction, one could at least make better than 50/50 predictions upon what might happen in the future.

That was the origination of charts. In effect, the fundamentals that are really important are often reflected in the chart itself. The fundamentals of the economy, and trade wars, and government debts, and supply and demand within an industry—a lot of that ends up being reflected in the chart itself, if one becomes astute at trying to ascertain what the chart is telling you.

I do not believe that charts predict price. There are many technicians who would say that. I'm not in that camp. What I do know is that charts tell me three things. First, they tell me the trend of the market. Where has the market been?

Second, they tell me whether a given stock or commodity is presently in a period of congestion, or in an active trend. Lastly and more importantly, as one becomes a little more sophisticated with chart techniques, charts can say an awful lot about a trade that might present an asymmetrical reward to risk ratio.

Do you have a favorite pattern?

The pattern I like the best would be the old, traditional head and shoulders pattern which tends (if it's a head and shoulders top) to characterize a market where strong hands who perhaps have owned that stock for a considerable period of time are dumping it. They dump a little bit, then as the market retraces, they back off and may even buy a little bit. It propels the market into new highs—and it's that new high (the head) where they really end up distributing the large share of what they owned. It's where they really cash in. In the process of cashing in, the market breaks back down and that is the head. Then you generally get one more rally where people who missed the boat try to get back in, and you get a right shoulder that fails to get up to the level of the head, and then when it rolls back over, you can get the completion of head and shoulders.

I also like the rectangle pattern, when a market rallies up to a point, falters, falls back down, rallies back up to the point it was at, then falls back down to the point it was. It tends to form a box—which indicates that you have a market where you have an equilibrium between supply of shares (or commodity) and demand of shares.

This may develop over a course of 10, 15, 20, or 50 weeks—where there is a tight equilibrium, perhaps within a 10 percent range of the value of the commodity or stock. All of a sudden, a market launches into a new high, higher than it had been during the point of equilibrium, and that is expressed by a large expansion in turnover of volume. That is a sign that the conflict, the equilibrium, is now over. The balance of power is now with the holders of stock, the buyers of stock. So I like the rectangle.

I also like what's called a right-angle triangle, where in a bull market a market rallies up, meets resistance and falls back down, rallies back to the point of resistance but falls down again, although not by as much. Well, there you have a situation where you tend to have fixed supply at one level, but a demand which increasingly is aggressive in owing the par-

ticular asset in question. Again, you come to a point where perhaps you all of a sudden break through that point of resistance, where the supply line was, and one can see that that happens on an expansion of turnover in volume which generally indicates to me that the bulls have won out. Of course the same thing can be said for a bear market where you have descending triangles, rectangles and so forth.

For me, those are the patterns that I tend to focus on the most—among the group of probably 10, 15 or 20 different patterns of classification.

Do markets have personalities?

Well, I mean, take cryptocurrencies. They're extremely volatile. They're extremely emotional. They'd rip the head off of a stock trader. It's not unusual to see a market change 20 or 30 percent in value in the course of a 24-hour period. So that's a market personality of high volatility.

Other markets tend to trend very well. The trends that take place in a market may be very well behaved, very orderly, and not subject to a lot of erratic behavior. That would be a market trend, like euro dollars, which is basically the interest rate paid on US dollars held overseas in Europe. That's a market that tends to be quite orderly. The Canadian dollar—that currency tends to be quite orderly. So you have market differentials like that. And of course the Nasdaq markets. They tend to have a little bit more volatile swing to them then the blue chips. Then the Dow itself. And, the tech stocks tend to have a little bit more volatility than the manufacturing industry.

What's your best trade ever?

I've had some big trades. For me a big trade tends to be a trade that might return 30 percent against my entire nominal capital. Not a stock that goes up 30 percent. I'm talking about a stock that returns 30 percent during the course of a fairly brief period of time—two, three, four months—against my entire capital base.

I've had been some of those. Also the long side of the New York Composite Index, which used to be a futures contract back in 1987. 1987 was my best year ever. Of course, it was the year of the big October crash and I wasn't involved in that. But I had done substantially well in the first quarter of that year on the long side.

The bull market in crude oil 10, 15 years ago was a market that was very rewarding to me. I've done quite well in the Canadian dollar. The best trade I've had in 2018 is betting on the depreciation of the Turkish lira. When I put on that trade, there was not a lot of volatility in the cross rate between the dollar and the lira. Because it was a trade that had such little volatility, I was able to put the trade on in size, but still limiting my risk to that 100 basis level.

Of course, the Turkish lira has basically declined in value against the dollar this year by almost 50 percent. For me, that was an outstanding trade, where I was able to not risk nearly as much as I was able to make in the trade.

I did very well a couple years ago betting against the Chinese yuan. The Chinese yuan had gained in value against the US dollar for years, for decades, in fact. It then made a low in 2014 and then went sideways for two, three years. We saw a sharp appreciation of the dollar against the yuan from the third quarter of 2015 into the fourth quarter of 2016. Again that was a trade that had very little volatility, but yet seemed to be a trade that offered great asymmetry from a reward-to-risk standpoint, and I was able to put on larger size trade than often is the case.

The trade also had a great potential to become quite valuable, and become volatile in a good way. People say they don't like volatility in markets, and I generally don't like volatility in my assets—but I like volatility in a market if I'm on the right side of it.

Have you ever considered yourself an investor?

No. I'm not an investor. In some ways, I wish I would have been. I wish I would have had that mentality.

Why's that?

If you're an investor and approach things in a certain way, you can do quite well—maybe not as well as a proprietary trader can do—but you can do it with a lot less stress.

You do have some stock traders who hold positions for a year and up, who probably qualify in the investor category. But for me a trade that I've been in for four months has gray hair. That's more a function of who I am, what my personality is, than what I might take as the optimum way to actually make money in the markets. I tend to have a swing trader's personality, so that's what I have been.

A few questions on social media. You use Twitter a lot.

I do.

How do you manage your engagement?

Well, quite a bit of my tweeting is done by staff. Then there are tweets where I chime in. I think Twitter is a great way to gauge the conventional wisdom of a market. There's nothing I like more than finding a market where there is a fixed conventional wisdom—where everybody that you can hear is singing from the same hymnal.

An example today is that there's basically zero bullish sentiment for interest rate futures markets. Everybody thinks US interest rates are going up. It is locked into conventional wis-

dom. It's hard to find somebody who would say that US interest rates are not going higher. I love when I can find a market where you have that kind of conventional wisdom—and where I can see on a chart that conventional wisdom might be wrong. Those cases often end up being my most profitable trades of the year, when I'm betting against the markets.

So I'll post a chart on Twitter, to see the reaction. We've seen a big change in the discussions on Twitter, in the past two years. I think it's very different today, because of the crypto crowd. I tend to engage the crypto community in an adversarial way—but in my mind, with fun. What I refer to as the "cryptomaniacs" consider me a hater. I'm not a hater. But that's the mentality of the crypto community. For them it's a religion.

When I joined the Board of Trade—and let's say I'd go into the corn pit, and the guy next to me was bullish corn, but I'd say I want to be short corn. That guy never looked at me and said, "You're a hater." I'm just taking the other side of a trade. It's what makes a market. So I find Twitter to be fascinating to observe a whole new generation of investors in a whole new category and what kind of mentality they bring it to bear.

Were you on Twitter before crypto Twitter?

Yes, but I became more active. When Wiley published my book, they set me up with a Twitter account, but I didn't tweet with the same frequency as I do now. I view it as a verbal ping pong game between me and the twitter community.

Nathan Jaye is a keynote speaker and contributor to Enterprising Investor.

https://www.cfainstitute.org/en/research/cfa-magazine/2018/why-self-sabotage-is-the-greatest-trading-risk