Transcript

THE ARTFUL TRADER

Episode 5: Crafting your own bespoke trading style with Jack Schwager

Michael McCarthy: How did the greats of the trade become the best, and is there any one thing that they all have in common?

Jack Schwager: That's a key thing that I think is true of everybody I interviewed. They're almost completely different than their approach. But the one thing they share is they've developed their own style.

Michael McCarthy: In this episode we talk to Jack Schwager who has met and interviewed the best traders in the industry, and collated them into his famous Market Wizard books. But should new traders copy the world's best?

Hi, and welcome to The Artful Trader. I'm Michael McCarthy, the Chief Market Strategist at CMC Markets Asia Pacific. In each episode we'll hear the highs and lows from the trading experts, and discover their journey to mastering the art of the financial markets. There is possibly no one in the industry who knows better the styles and approaches of the world's greatest traders than Jack Schwager. Jack has interviewed them all for his Market Wizard series. The four books start with market wizards, and lead to his most recent offering, Hedge Fund Market Wizards. Who better to interview the top traders than a trader himself. Jack Schwager started out on the floor before heading up futures research for some of Wall Street's leading firms. He was a partner in the Fortune Group, a London based hedge fund advisory firm. Joining us from Boulder, Colorado, welcome Jack Schwager to The Artful Trader.

Jack Schwager: Hey Michael.

Michael McCarthy: Jack, your first Market Wizards book came out in 1989. For many young traders, myself included, it was one of the first books we were given to read. For those few listeners who don't know, the Market Wizards is a collection of stories from great traders around the globe. Now at least one whole generation of traders have grown up having cut their teeth on the Market Wizards books. Do you feel a special responsibility here Jack?

Jack Schwager: I don't know if I feel a responsibility, but I do acknowledge that for better or worse there has been that influence. One of the things that certainly has happened to me so many times that I can't count, is people coming up to me and telling me, I got into this industry because of you. Now presumably if they're still in the industry, and they're telling me, that's good. So it has benefited their lives, and that's great. But being someone who is statistically oriented, I do recognize I don't know what number of people read the book and lost money. So I don't know what number of people failed. But I certainly have had a tremendous number of people, including quite a number of hedge fund managers tell me that the books were what got them into the business.

Michael McCarthy: It's not surprising, Jack, that the stories are very strong. I mean you've met some of the greatest traders seen over the last few decades. Who did you find the most impressive?

Jack Schwager: I always find that very difficult, because when you're trying to compare people, like Kovner, and Druckenmiller, and Thorp, and so forth, [? 03:16 Shaw], it's very difficult because there are so many traders who are phenomenal in their own right that it's very hard. I mean you could say well maybe these 20 if I had to, or these 10, but to just say one is extremely difficult. Now if I had to say one person who was actually the most impressive just for the scope of achievements, that would probably be Ed Thorp. Not only because he had this phenomenal track record.

He ran two hedge funds. The first one ran 19 years. He lost money in three months in those whole 19 years, and each of those losses were less than one percent. His annual return before fees was about 19 percent. So the return risk on that is so far off the charts it's unbelievable. But it's not only that, there's a fellow who is our PhD mathematician. He would have been a PhD physicist, but he felt he didn't know enough math, and while he was writing his thesis went to study math, and ended up getting his PhD there, and never finished his physics thesis.

He also did stuff like, he was the first one to come up with the mathematical equivalent of the Black-Scholes Model, the option pricing model, which he used many years before it was finally published by Black and Scholes. He had actually discovered a very mathematically equivalent approach years earlier, and for that period of time was probably the only person in the world who knew how to price options correctly. He was the first one to start a market neutral fund. The first one [? 04:50] that arm. The first one to do a convertible arm. So he had such a scope of achievements that I'd say, if I've got to pick one I'd say Ed Thorp. But that doesn't mean a lot of these other traders I interviewed who had phenomenal achievements are any less than completely exemplary.

Michael McCarthy: Jack, did anyone surprise you?

Jack Schwager: That's a good question. One example of surprise was somebody who I knew well even before I interviewed him. That was Michael Marcus, who was the first interview, chapter one of the first Market Wizards book. He was extremely reluctant to do the interview. In fact, he turned me down originally. Only because we knew each other, and because our mutual friend campaigned on my behalf, and convinced him to do it. At the time he lived in Malibu, and actually he had Rocky, Stallone's old house, that's who he bought the house from, overlooking the beach in Malibu and all that. So I knew going in that he didn't want to do the interview.

I ended up doing this interview for the full day from morning, afternoon, and all the way through the evening. It turned out that he was remarkably candid, and remarkably open. For someone who didn't want to do the interview, to be that brutally honest, and to share so many personal things about his failures, I guess that was surprising. It was a pleasant surprise. So there was an interview. It was my first interview. I was apprehensive about would it work out. Then it turned out to be one of the best interviews I ever had in any of the books.

Michael McCarthy: Jack, I think it's Michael Marcus you quote, 'Follow your own light.' This is a recurring theme in your work. Your first rule of trading is there's no single true part to becoming a market wizard. When you're out here in Australia speaking to the CMC Masterclass series, you mentioned there is no holy grail to trading. Can you expand on that theme for us?

Jack Schwager: Sure. You're right on both counts. It was Michael who said that. It is a core part of my beliefs and message to all traders, that one of the most important things you can do is develop your own style and methodology. I did a webinar a few days ago. There were questions at the end of the webinar. One of the questions was, Jack, what do you think about the S&P? I said, the first thing I've got to say is, and I would be dishonest if I said anything else. You don't want to know what my opinion is. Because one of the pieces of advice I always tell people is you don't want to ask other people what their opinion is. You don't want to be influenced by other people, even if they're smarter than you, even if they know a lot more than you, which I don't say is the case in my case.

But no matter who it is you don't want to try to style your trading to copy somebody else, it's just the wrong approach. One of the things that I found, and actually there's a line. I forget which trader said it. But it was along the line, I'm paraphrasing, that every successful trader I've ever known has had their own trading style. That's a key thing I think is true of everybody I interviewed. They're almost, to a man and woman, completely different in their approach. But the one thing they share is they develop their own style.

I can't think of anybody that I interviewed who sat at somebody's knee, and learned an approach, and that's what they did, and they did it so well they became really great at it. There's no interview I can think of that falls into that category. Everybody developed their own approach, and those approaches can be radically different, and even contradict each other. So I've had traders who have said, like Jim Rogers, who is completely cynical about technical analysis. He throws out a line like, I never met a rich technician, unless you count those that sell their services.

Then you have traders like Schwartz, who spent his career on Wall Street selling the fundamentals of stocks, and trading on the fundamentals of stocks, and by his own admission lost money continually. Then became phenomenally successful as a futures trader trading on pure technical analysis. Looks at people who say that technical analysis is a bunch of nonsense, like Rogers does. Not quoting, not that he's talking about Rogers, but about people with that opinion. He believes, what a bunch of nonsense. I became rich doing that, and I failed using fundamentals. So you can find people who are 180 degrees apart on what is the right approach. So that tells you there is no right approach. But there is a right approach for each person, and neither you nor I can tell them what that is, they have to discover that on their own.

Michael McCarthy: So how do they discover their trading style Jack?

Jack Schwager: Trial and error. Look, I'll use myself as an example. I started out because I come from an economics degree background, immediately cynical and skeptical, like Rogers, about technical analysis. For the first number of years I was in this business, never looked at it, or considered it, or gave it a second thought. But through the influence actually of one of the analysts I had working for me. I was a research director at the time, and I had a bunch of fundamental analysts who worked for me, and reported to me, and I had one technical analyst.

I noticed the technical analyst, who also had become a really good friend of mine, by the name of Steve Kronowitz. I noticed he was the only one in the group that was actually right significantly more than wrong. So being open minded I asked him, Steve, tell me what you do. Through that process I learned technical analysis. I also understood through talking to him that it's not mumbo jumbo, there is a rational explanation for why it should work. It should work because no matter who you are, no matter how big or small a trader you are, no matter what information you have, everything that any trader does gets reflected in the market.

So it's not like trades are being executed, and nobody sees what they are. Anything that is done is reflected in the market and the price. So it is not a far stretch to say that that price should contain real information, because it's showing what all the smart and dumb money is doing, right? In my own case what I ultimately found was that a fundamental analysis didn't work for me. Technical analysis I found was much more effective, and I felt much more comfortable with it, and I could use risk management well with it. So I went from being a purely fundamental trader, and unsuccessful at that approach, to being a technical trader. I was never a great trader, but at least I was net profitable.

Michael McCarthy: I'd like to focus in on those traders who have discovered their edge. I mean in your interviews with them did many of them give away the secret to their trading edge? Were they worried about that?

Jack Schwager: Some more than others certainly. Whether they gave away anything or not, I know I've had readers tell me that they style their approach, or learned, got their basic ideas out of particular chapters. At least in some cases people said enough for other people to be able to develop trading methodologies off of that. But nobody...Actually I shouldn't say nobody. There are some people who were very specific. But for the most part they didn't spell out exactly what they do. Once in awhile I'll look at Amazon reviews. Those Market Wizard books, they, I'm not patting myself on the back, but just reader reactions are basically very positive. So a fair large majority of fives, some fours. Then you have a tiny percentage of people who have ones or twos, maybe two or three percent. So you wonder, they're reading the same book.

If you look at those reviews, other than the ones that are complaining that they didn't like the paper, or something like that. The ones that are talking about the content say something like this, there was not a single specific system in here, or something like that. The idea was this fellow bought the book, and he was expecting someone to say, you want to make a million dollars a year, you do one, two, three, four, five, and you'll make a million dollars a year. Now there are people who will sell them that, but he didn't get it out of the book.

So therefore he felt there was not a single worthwhile trading idea in the book. Whereas of course the majority of people find there's a tremendous amount of trading ideas in the book. The ones who don't are those who are probably rank beginners, and have this real misconception about what trading involves, and what success involves. They think there's some sort of secret, and if the book doesn't give it to them on a silver platter, they think it wasn't worthwhile.

Michael McCarthy: They don't sound like the types who are going to make it as a trader, Jack.

Jack Schwager: No. They probably won't. They don't have a realistic concept of what's involved.

Michael McCarthy: I mean you've established quite clearly that the right style for any given trader is as much as product of who they are as what they trade. But given that, do you see similarities between approaches that you could draw upon? I mean are there characteristics, or mentalities that most successful traders use?

Jack Schwager: No on the characteristics. The mentality, maybe. Characteristics, no. You've got as broad a range of personalities among the people I interviewed as in any other group you'd want to take. So you've got people who are very aggressive. They could be Marine sergeants, and in some cases were. You've got people who are just very shy, withdrawn, and quiet. The personalities are all over the place, so that's not a commonality. For the most part of course there are commonalities. There are commonalities in such things as the respect, the understanding that risk management is the most important thing in their whole trading methodology. So that is a commonality. There are lots of common denominators like that. Understanding that you have to be very very flexible. That you can't hold an opinion rigidly, you have to be able to turn on a dime. Dogmatic people I think would do terrible as traders. Patience. There are a lot of similarities in things traders do. Not so much their personalities, but there are certainly commonalities.

Michael McCarthy: Jacks, as traders, mistakes and learning from mistakes is an important part of the process. You're in a rather unique position in that you spoke regularly, and then continued to do so with many great traders. Have you ever been tempted out of your comfort zone in those conversations? Have you ever done anything in the markets that you possibly shouldn't have?

Jack Schwager: Like anybody who has ever traded the markets I've done stuff I shouldn't have.

Michael McCarthy: Have you ever been tempted to take a tip?

Jack Schwager: Oh yeah. That has certainly occurred, or being influenced by somebody's trading opinion. In fact, a mistake I made where I was influenced by another trader's opinion on a market. At the time I was going away on a business trip, and I had that position, and he was on the other side. These were pre cell phone days, I wouldn't be able to follow the markets type of situation. Against my own better judgment, after the markets close, before I left for my trip I went to the overnight desk and got out of my position. It was a cop out, because I could have just had a [? 17:03] cancel stop. So by saying I couldn't follow it, that was absolutely true. But it was still a mistake because I could have used the stop. Of course when I came back the market had gone several hundred points in my direction. So I've had those experiences in the past, and I can't think of a single time where listening to anybody ever was helpful. I can think of times where it wasn't. Usually they were listening to people who were better traders than I was. So I just a long time ago decided that you don't want to listen to other people's advice, it will just mess you up.

Michael McCarthy: Fair call. What's the most unique style you've seen Jack?

Jack Schwager: Actually there is one absolutely answer on that. Because there was one trader I interviewed who was so radically different than everybody else. It was this fellow called Jimmy Balodimas. He was a prop trader for a New York firm. The thing that was so different is that he literally broke just about every trading rule you can imagine, and somehow managed to be very successful despite that. It is a bit of a paradox for me. I can't even tell you. I try in a chapter to explain why he is still successful. But this is a person that would when you get markets that go radically in one direction, where the market is on a complete tear in one direction, he will step in and take the other side.

So remember five, six, seven years ago, whenever it was that silver was going straight up and making, it was like a wall. It went in the 30s, 40s, and eventually about 50. When it's in the 40s just going up, crazy like a vertical cliff, he's in there selling. So this is the type of trading he would do. It went into his nature of being contrary. He just had to fight everybody. That was part of his nature. I even think the first line of that chapter is Jimmy Balodimas breaks all the rules. I think the first line of my summary at the end of the chapter was, don't try this at home. Because my belief is that 999 out of 1,000 people who would try anything like what he does will lose all their money. So I don't think it's an approach that anybody else can do.

He pulls it off. I do have a sense of why he pulled it off. I should say here that, and I do disclose in the book, full disclosure, the reason I found Jimmy was my son was actually a trading assistant for him. So he would tell me, dad, you wouldn't believe the guy I'm working for. That's how I know he's for real as well. Anyway, so he would trade a lot, like maybe 500 trades a day or whatever. I'd say he was bearish to market. He might be selling into a bull market. But every day if a stock he was short went down a little bit, he'd buy it back. So he was always trading against his positions.

He was so good at capturing these profits, even when he was on the wrong side of the trend, that even in a month where he was on the wrong side, and the market went a few percent against him, he'd at least break even. When he was on the right side of course he'd do extremely well. So it was that skill in trading against his positions that compensated for the fact that he would sometimes be on the opposite side of a screaming trend. Even though I tell everybody, or I make it very clear nobody should trade like Balodimas does.

The one thing I took away from that interview that is really relevant to just about anybody is that the lesson to be learned is that trading is not a static process, it's a dynamic process. So most traders, or a lot of traders think of trading as a two decision endeavor. You have to decide when to get in, and when to get out, and that's it. But it's not. There's no written rule that you should get in 100 percent at one price, and out 100 percent at one price. So the idea that if you're let's say in a position, and it goes let's say in your favor, you don't want to just take small profits. But if it goes enough for, in your direction quickly enough, there is a lot to be said for taking partial profits, looking to reinstate by say taking partial profits, whatever your approach is. Taking it at a point where you think the market might meet resistance or reaction. Then taking part of the profits and looking to put it back in if you do get the reaction.

So that type of process not only will lock in profits, and make you, if the market does have a reaction allow you to get back in, and get more profits than you would have otherwise. But it puts you in a really strong position. Because if you had the entire position, get a profit, and the market starts coming back, you're worried about losing it all, and you probably just [? 22:03] out of your whole position. Whereas if you've taken partial profits you're actually almost want it to come back a bit so you can put it back on again. It puts you in a much stronger position.

So I think that mentality of trading against a position can be useful in many ways. I think that is potentially a powerful tool for traders who have only looked at trading as an in and out proposition. As opposed to something which is dynamic, and the position can be scaled up and down based on market movements. So that's what anybody can take away from the Balodimas interview.

Michael McCarthy: Jack, one of the things that almost all traders do around the globe when they get together is tell the stories of their most memorable trades. Naturally given your overview of trading and traders, our listeners are very interested to hear what you might regard as the best and worst trades you've ever seen.

Jack Schwager: Let's take Stanley Druckenmiller. This is going to be both the worst trade ever, and the best trade ever kind of in one story. So Stanley Druckenmiller. For those listeners who may not know who Stanley Druckenmiller is, Stan ran his own hedge fund for I think well over 30 years. He is now retired. But over that 30 year period or so he averaged close to, he compounded at close to 30 percent a year. He also ran during that period of time for a good chunk of time. I don't know exactly, seven years plus give or take, he was actually managing George Soros's primary fund. This was when George Soros was in Europe, and when the Berlin Wall fell, trying to get those countries leaning towards a capitalistic system. He was trying to influence the situation. He was really focused in one that a lot more than the markets.

Stanley Druckenmiller was doing the day in, day out trading. So that's who Druckenmiller is. Druckenmiller at the time, this was before he joined Soros. He was managing seven funds for Dreyfus. It was in 1987. For several months at the time he had been net short the stock market. Then on Friday October 16th, 1987, that week the market had been down sharply, and also very much on that Friday. It came so far down that Stan said to himself, well should be support here is probably going to [? 24:36]. So what he did is covered his entire short position, and leveraged long on that Friday close. This is the Friday before the big October 19th crash, which is the biggest one day decline in the US market in history, and probably bigger than most one day declines almost in any market ever experienced.

The market in futures which were not locked, which were trading, the market was down I think 29 percent on that Monday. So imagine switching from short to long the day before the market is good to go down 29 percent in one day. So you cannot make a worse mistake. Now the best trade ever, and again Druckenmiller, that same trade. Because if you look at his record for October '87, he almost broke even. How could that possibly be true? Well he was short for the first half of the month, so he was making money. But here's the thing, over the weekend. The reasons are tangential to this question and answer. There are reasons why he decided he had made a bad mistake.

So he knew over the weekend he should not have reversed his position. So he had intended to go back short on Monday. The problem is he comes in, and the market is down, gap is down 10, 12 percent right at the start. So what does he do, with the market gapping down from where he had just switched his position? He switches right back, and he gets back and it's short. So you think about the flexibility of a trader to go from net long to short, have the market cap down 10, 12 percent, not hesitate for a minute. To hope that maybe it will bounce back in a little bit, such a big downside gap. But not only gets out of the position, but reverses back to the original short, 12 percent down from where he got in. That's just remarkable. So it's both the worst trading mistake ever made that I came across, and probably maybe the best trade ever as well.

Michael McCarthy: Will robots take over the markets?

Jack Schwager: That's a good question. Maybe at some point. I guess by some point, I don't know if that's 30 years, 50 years, or 100 years. So given the incredible progress, the exponential progress we've seen in computing power, as well as computing algorithms in the realm of artificial intelligence, I'm reluctant to say never. Because things people thought were impossible for computers to take over a decade or two ago have become reality. So in that respect at some point it may happen.

If it does happen the official market hypothesis proponents will finally be right. But I would add that it's a far more complex thing to achieve than say something like getting computers to excel, or to beat humans in chess. So that was a difficult problem, but in orders of magnitude it doesn't come close to the markets. Because in chess you have well defined moves, which don't vary. There's only a certain number of possible moves. The markets however, you're dealing with a lot more elements that influence prices, a lot more players. Even more critically the effect of any particular input does not stay constant, it can vary greatly over time.

So you may go from situations with say monetary policy is a big influence on the markets, to where it's not an influence at all. You can have situations where stocks and bonds go up together, and you can have situations where they go in opposite directions. So even the individual elements of the markets don't maintain their same reactions and directions. So it's an exceedingly complex problem. But clearly there are groups, again, some of which I have interviewed, like Paul Thorp, and [? 28:46]. Ones that I haven't like [? 28:50] who has a phenomenal track record, who have used computerization, computerized approaches to excel at the market. So even now it is being done. But to the point where the computerized approaches are exclusive, I think that point is still a ways off.

Michael McCarthy: Jack, what are you working on now?

Jack Schwager: So my endeavor at the moment is a Fintech startup where I'm a partner, called FundSeeder. FundSeeder is a platform for traders. Right now it's a platform for traders who are also building a platform for investors, allocators. So the idea of FundSeeder is to discover undiscovered global trading talent, and be a connector between those set of skilled traders anywhere on the globe who may be able to trade, but have no way of attracting investors. That's easy to see. You could think of countries like Eastern Europe, or Asia, or any other than the G7, where even if people were good traders they'd have no way of really attracting capital. Even within developed countries, even within the US or UK, you can have a lot of traders who are skilled, but don't have the pedigree, don't have the connections, whatever, and they'll have no way of getting in front of the right people, or getting serious attention.

So at FundSeeder our idea is to have a platform where these traders can link their actual accounts to the platform, use a whole set of analytics for their own benefit, to risk management, to analyze their own traders trading improvement, whatever. But most importantly for us to be able to discover them, to verify their trading because we're getting the data directly from the brokerage. Then use that database of traders as a resource for an investor site where allocators can go and find undiscovered trading talent. So that's the basic concept. We spent the first couple of years developing the platform for traders, and getting traders onto that platform. That will greatly expand as well. But right now we're developing the investor platform. We expect that within the next year we should be acting as a conduit with the investor platform for significant allocations to these traders that are selected. That's fundseeder.com, for the website.

Michael McCarthy: So is this a way of finding the next market wizards Jack?

Jack Schwager: Yeah. That's actually one thing that it can do as well. It's not for that reason. But one of the plans is that after the site has been running for a few years, and we've got track records of enough length, and enough traders, that the next market wizards book would be one with a working title of undiscovered market wizards. That would really be basically from people we found via this web solution to finding traders.

Michael McCarthy: Jack Schwager, thank you very much for your generosity with your time, and your knowledge. Our traders and our listeners will no doubt benefit.

Jack Schwager: Oh, thank you very much.

Michael McCarthy: That was Jack Schwager. For more information about his books, and for an exclusive blog post written by Jack, head on over to theartfultraderpodcast.com, where new and current clients can also access some limited time offers. The Artful Trader is an original podcast series by CMC Markets, a global leader in online trading. To stay up to date with the new episodes, subscribe now on Apple podcasts, or wherever you get your favorite podcasts from. Make sure you share it with your friends, and leave us a rating. I'm Michael McCarthy, and this is The Artful Trader.