WHY TRADERS LOSE HOW TRADERS WIN

Timing Futures Trades With Daily Market Sentiment

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Introduction

My first venture into the futures market was in 1968. A broker promoting shell egg futures badgered me incessantly. I borrowed the money to open an account with him just to get him off my back. Before too long, I was making money. Within several months, my starting capital had been multiplied severalfold, none of it my doing. My attention had been captured. The futures bug had bitten me. I didn't realize then that my life had been changed, the course of my relationships altered, and my professional future dramatically influenced.

By the time I had decided to learn everything I could about futures trading, my investment had grown even more. A little knowledge proved to be a most dangerous thing indeed. My market studies were barely completed when I decided to expand into pork belly futures. Inspired by the success of my transactions in shell egg futures, transactions which were entirely the doing of my broker, I plunged headlong into bellies and, of course, very quickly lost all the money I had made in egg futures during the preceding six months.

After the initial shock and remorse of my painful lesson had been fully digested, I realized that there was much much more to futures trading than I had ever suspected. I understood that what I needed to learn was not to be found in books. I needed to develop my own style, method, technique or system, which would be based upon a rational theoretical analysis of futures trading. But my youth and inexperience would prove to be significant obstacles in developing these necessary skills. Little did I realize that in setting out to develop trading systems and theories, I was ignoring the single most important factor in futures trading—psychology. And this was especially ironic since my college training was in clinical psychology.

For several years my work on trading systems, methods and timing indicators continued at a feverish pitch. I acquired historical data. I read book upon book about timing signals. I studied numerous charting techniques and subscribed to many advisory services in order to complete my education. I discovered cyclical analysis, seasonal price tendencies, on-balance-volume and more. Eventually I was ready to apply my knowledge to the markets.

At first my success was limited. I found myself personally insulted by each loss. I was unwilling to admit to losses. When trading well, I was concerned about how long success would last. When extremely successful, I became overly confident. My reactions were not substantively different from those of almost every futures trader. It became very clear that trader psychology—indeed my own psychology—was at one and the same time the weakest link in the chain of success, and the strongest. It took me nearly a decade to finally believe this realization.

With the insight that trader psychology was the quintessential element for long-lasting success came the realization that my professional training in clinical psychology and behavior modification were tools which I had ignored for all too long, powerful tools which gave me the understanding I needed to achieve my goals as a futures trader.

On a summer day in August of 1984, Bob Tamarkin, at the time a writer for the *Chicago Sun Times,* called me. He was writing a book about futures traders and wanted to interview me. He claimed to have read about my work in the markets and wanted to include an interview with me in his book, *The New Gatsbys*. Flattered, I agreed to the interview and met him at his office in downtown Chicago. On my way to the interview I couldn't help but wonder what he would want to know and how he would use the information.

I spent the next several hours under a psychological microscope. How did I trade? What were my feelings about winning? About losing? What were my plans? How much did the opinions of others affect my conclusions? What was my lifestyle? How did my childhood affect my view of the markets? What were my parents like? I thought the questions would never stop. But they made me think.

I've come to realize that some of the greatest insights occur to me when I'm not looking for them. Sometimes I can look at the same three pieces of a puzzle in the same way I've seen them hundreds of times before. Suddenly a different perspective will fortuitously reveal a different arrangement and an entirely new point of view. And this is what my interview was all about. As I sat and squirmed in my chair under Tamarkin's probing eyes and bushy eyebrows, old pieces of the trading puzzle began to rearrange themselves. Exactly what he said, I'm no longer certain. All I can recall is leaving his office on Michigan Avenue with a new perspective, a new "Weltanschauung" (world perspective) which would mediate my understanding of the futures markets profoundly and persistently for years to come.

It was during the course of Bob's interrogation that I realized how much my attitudes and opinions in the futures markets were a function of my early childhood life in the slums of Montreal, Canada. My successes as well as my failures were intricately intertwined with these and other significant experiences. My parents' experiences in Auschwitz and Dachau; my very early childhood in the Bavarian Alps; and my sudden injection at the age of thirteen into Chicago's affluent North Shore from an impoverished existence in Montreal, were all formative factors in my life as a trader.

It became clear that the roles of attitude and opinion in futures trading were tremendously important. To ignore them was to ignore a wealth of information. To understand attitude and opinion in myself and in others was to befriend a great ally. And with this insight began my informal study of market sentiment; a study which would never be complete, but which would continually provide new understandings of market and trader behavior.

This book represents the culmination of many years' experience in the trenches of futures trading. It also represents the distillation of my years as an observer of trader behavior, a skill which I acquired during my years in the field of human psychology, behavior modification and projective psychological testing. While my observations and theories are not strictly scientific, my efforts in developing and understanding market sentiment are based upon scientific procedures. But futures trading is not a science. Futures trading is awash in emotion. And emotion is the raw material of market sentiment; it is the stuff of which trades are made. It is the enemy of profit—the accomplice of self-destruction. Yet, emotion harnessed and understood is the substance of success. Does this all sound paradoxical to you? Does it sound like I'm saying at least two different things at the same time? Yes, I am!

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PART I

The Nature of Market Sentiment

Our study of market sentiment begins with an examination of several case studies in trader behavior. I've changed the names of the participants; I've deleted some irrelevant details and I've expanded on important aspects of each case in order to illustrate my points. After presenting the case studies, I will analyze them in terms of market sentiment. As you read them, I urge you to put yourself into the position of each main character. Attempt to identify feelings and behaviors you have observed in your own trading behavior, attitudes and opinions.

In Part 2, I will present several different methods for applying daily market sentiment (DSI). Part 3 provides a day-by-day and weekly history of the daily sentiment index readings back to the first day of their collection in April of 1987.

Part 4 provides a collection of historical charts with daily market sentiment data which may be used for your further study of the principles you will learn. These charts are currently unavailable from any other source and will prove extremely valuable in your research with market sentiment.

CHAPTER 1

The Secret Life of Traders

The three tales which follow will serve as real life examples of how trader sentiment and psychology are hard at work every day in the futures markets; how they influence the markets; and how they are influenced by the markets. While the names of the players have been changed, and details have been reconstructed, all situations are based on real events.

Jerry's Bellies

At 6 A.M. the traffic south on I-94 isn't too bad. And when Jerry makes his return trip, usually at about three in the afternoon, he'll beat the traffic back to his large suburban home. There's that Chicago skyline again; Sears Tower, the Hancock, the early morning summer haze, probably pollution, he thinks, but it's still not as bad as L.A. He reviews briefly the upcoming day: another day in the pits; some yelling, too much pushing, considerable strategy, possibly several minor errors, and at least a few thousand bucks. It's all in a day's work. And then it's back home again. He's done it so many times now, it seems mechanical, even easy, like watching a champion diver or gymnast. The moves seem to come almost naturally; they flow and blend into winning ways that appear to be inborn.

Behind the seemingly automatic performance are years and years of intense practice. And everyone watching knows that it's not nearly as effortless as it appears to be. It's the mark of a professional to make things seem easy. But for Jerry, as for a vast majority of futures traders both on the trading floor and off, things were not always so predictable.

When pork belly futures began trading in the 1960s, Jerry was one of the first traders in the pit. He's learned many lessons since then, perhaps the most important being that successfully trading pork belly futures is difficult. Of course he knew that making money consistently in any futures market was among the most challenging tasks possible. When he first came to the pit at the Chicago Mercantile Exchange he was just as "green" as many of the other traders. He came to the trading floor with a host of preconceived notions similar to the excess intellectual and emotional baggage that accompanies many traders when they make their first venture into the futures markets.

Having come from a wealthy family on Chicago's affluent North Shore, Jerry attended some of the best schools in the United States, and he did well. He learned his history, political science, his mathematics and physics, and, to be sure, his economics, a subject which he found truly fascinating. Like many other "North Shorite" offspring, Jerry was sitting in the catbird seat: he was an only son, his older sister had married into money, his father owned a successful meat processing business, and he was the heir apparent. To this end, the persual of business and economics were logical. After all, his father reasoned, Jerry would need to know about the family business in order to run the company successfully. Nowadays economics was so important, that a good background in theory couldn't hurt!

His car parked, Jerry takes the short walk over to the "Merc" building. The cloak room clerk recognizes him immediately and has his gold-colored trading jacket waiting on the counter. They exchange a few perfunctory words about the Chicago Cubs, but Jerry can't hear them. Assuming an intentionally diminutive posture, he strides on to the trading floor as he's done nearly five thousand times since the 1960s.

You'd think it would be boring by now. You'd imagine that Jerry must be tired of it all after so many years. But he's not. Is it just the money? Is it the thrill of the battle? Or is it the challenge that keeps him going?

Slowly strolling past the banks of telephones and row upon row of order desks, he sees the flashing telephone lights, hears a few telephones ringing desperately, and attempts to overhear some bits and pieces of conversation. Now at his desk, he scans the news wire with the eyes of a surgeon.

As a belly trader, Jerry is most assuredly tuned into the fundamentals of the market. He is aware of the latest storage figures, cash prices, and retail bacon movement. Tucked in the back of his mind are myriad facts and figures; the last Pig Crop statistics, hog price trends, open interest, the trend of corn prices, beef steer price trends, interest rates and the overall condition of the U.S. economy. He wonders about the situation in Iraq. Would a war be bullish or bearish for the meat markets? Do troops in combat eat more meat? Would the government freeze commodity prices in the event of a war? If so, what effect would it have on the futures markets? Jerry glances over the latest membership transactions and seat prices. He notices that some familiar names have left the floor, selling their memberships; some were veteran traders and a few others had only been there several years. He remembers the countless traders who have come and gone through the years.

Random thoughts emerge, are examined briefly, assigned their relative importance and dismissed as Jerry checks his positions. He is long approximately 130 July pork belly contracts from an average price of 65.45. Yesterday's closing price was 67.70; a tidy little profit in only three days! He reformulates his main concerns in order of importance: first, he will not allow this profit to turn into a loss; second, he must determine if today is the day to exit his position; third, he must develop a plan for liquidating his position in a fashion which does not affect the market. While 130 bellies is not an especially large position to dispose of, Jerry must consider the size of his position in light of several more important factors. First and possibly most significant is the fact that Jerry is well-known and respected (possibly feared) by the pit. Other traders watch him closely, some attempting to learn his winning style and others wishing to coattail his trades. A second important fact is that the size of a position is only important in relation to the overall trading volume and open interest in a market.

In a market which trades perhaps 10,000 contracts in one day, a 130 lot position is minor and will not affect prices appreciably. However, in a market which trades 1,000 contracts a day, a 130 lot is 13 percent of the day's trading volume.

Jerry now begins one of his most important activities of the day, the goal of which is to determine when and how to liquidate his position and whether, in fact, to reverse his position from long to short. He knows that he is being watched. He knows that other traders are aware of his every move and that they are in constant communication with their order clerks who in turn are in touch with "upstairs" traders and brokers. He knows that he can barely make a move without the news being flashed to traders throughout the country. And the importance of the news about Jerry will be very much a function of the position size he is trading. However, Jerry learned long ago, after many years of tremendous effort and mediocre performance, how to use trader psychology and mob behavior to his advantage.

What Jerry must do in order to maintain his success is to carefully monitor the consensus of opinion among his fellow floor traders in order that he may use it to his advantage. He must use what he has learned about mass psychology in order to win at this difficult and risky game. In order to do this, Jerry must not only know what "the floor" is thinking at any given point in time, but he must also know how to prompt them to action in order to "play" the market like a finely tuned instrument, something he has been doing for many years. Jerry has derived from his understanding of trader psychology a variety of strategies which he uses regularly in his trading. While his methods don't always work for him, they work often enough to allow consistent success.

After examining the trading data and assimilating the latest news, he calls a few retail brokers (i.e., brokers that deal primarily with the public). He's most interested in their opinions and they're even more interested in his, given his reputation as a successful trader. What exactly is it that Jerry can learn from his daily (and on occasion more frequent) talks with retail brokers? The nature of his questions will give us a clue. "Are your customers bullish or bearish on bellies?" he asks. "Bullish . . . uh-huh . . . how bullish? Are they primarily long or short? And how about your own work, is it bullish or bearish? I see, bullish. How bullish? How high do you think they're going on this move? How about your in-house research department? What's their conclusion? I see, bullish. OK. What do I think? It seems as if there are too many bulls around. We might be putting in a small top. Sounds like the public's too bullish." He hangs up the telephone. His suspicions are confirmed.

It doesn't take too much to turn the public bullish, he muses. He ponders again one of the market facts he has learned time and time again; the public is almost always wrong at important market turns. It's sad, it's unfortunate, it's true and, praise the Lord, it can't be helped. For Jerry and a handful of other market professionals, both on and off the trading floor, market psychology is an ally and a primary reason for their success. While it is not their intention to take advantage of the public, their goal is to succeed using whatever means they can, so long as they are moral, legal and ethical.

Jerry watches the crowd swell. Traders are taking their favorite places in the pit. He scans the crowd. There's Miles wearing his lucky tie, and Lee, sporting his lucky trading pants. A few other traders he knows well are anxiously pouring over charts; some studying trading-card-size point-and-figure charts in their order decks, and still several others off in a corner studying charts on a computer screen. Now he makes his move. Leaving his trading desk he walks toward the pit, at times pushing his way through the elbow-deep crowd. The public address system drones on, calling traders to the telephone endlessly. Anonymous runners with order tickets scurry to and from the pit like homing pigeons. It all seems very unreal to Jerry, even now, after so many years of playing the game. Jerry has his ears riveted to the growing roar. He is very interested in what other traders are saying; what they're doing; what they're expecting. He exchanges greetings with several traders, stopping here and there to gather more information about their expectations. Jerry knows from his years of experience that even the trading pit can be wrong. He has observed repeatedly an uncanny correlation between the degree of bullishness or bearishness in the trading pit and important market turning points. Even some of his most successful peers have been very wrong at significant market junctures, both long-term and short-term. And it has been a constant struggle for Jerry himself to avoid the emotion of the moment, going contrary not only to the crowd but to his own expectations as well. Like many a trader, Jerry has taken some of his worst losses when he enjoyed the greatest self-confidence, and when he held the strongest opinions about the expected direction of the market.

Now Jerry is in the pit. He knows what he must do. He has done his homework. Does he care about the fundamentals? Not a bit! Does he care about the opinions of other traders? Absolutely! So much so that he knows he must exit his position. He is uncomfortably aware of the fact that many eyes are upon him. Since he has accumulated a fairly large position during the last few days, the pit knows that Jerry is long the market. Should he raise his hands and gesture to indicate that he is selling, the news will spread like a brush fire, creating panic and undermining his own position. Even if he begins by selling just five bellies, the pit will fear that he is beginning to liquidate his entire position unless, of course, his five lot is gobbled up by yet another respected trader. Jerry can't afford to take the chance of "spooking" the pit. The opening bell rings, prompting a surge of activity. Hands reach skyward in virtually all areas of the crowded pit. "Five at 60 . . . five at 60," shouts Jerry, his hands moving toward him. Within an instant his bid has been hit. Jerry has just bought five more bellies at 65.60, ten points below the previous day's close. Is he making a mistake? Why is he buying when his plan clearly calls for liquidation of his position? And he's not through yet. As trading continues, bellies begin to drop sharply, declining ten to twenty points at a tick as only bellies can do. Soon the market is 120 points lower on the day. Jerry has been standing silently since buying his original five lot. Without warning, he throws his arms up bellowing "fifty at 40," bidding 64.40 on a 50 lot. Two traders rush in to fill his bid. One trader offers fifteen at 45. "You got it," responds Jerry, and turns quickly to accept another offer of twenty at 55 from a trader on his right. With great haste, he marks his trading card. He now owns a total of 170 bellies.

Some traders are now seen signalling from the pit to their runners. One in a multicolored jacket steps to the side: "Tell 'em Jerry's buying again . . . he's bought at least fifty-five so far this morning." The word goes out to the trading desk. The desk calls upstairs to inform the brokerage house. Brokers, upon hearing the news, push buttons to call their best clients. "Jerry's buying more July bellies today." "What are they doing now?" inquires the client. "Well, they were down over 100 until he started buying, now they're only down 25 on the day." "Let's add to the position" responds the client. "How many?" asks the broker. "Let's buy three more at the market."

The orders go in. Soon bellies have recovered their opening losses. And within fifteen minutes they're 30 points up on the day as the