Good Trading Is Not Rocket Science

By Tom Basso

Are successful traders smarter than unsuccessful traders, because they seem to be able to produce profits where other fail? Are smarter traders more able to discover the secret keys to success in trading? Although many struggling traders may believe successful traders are smarter, I know of no evidence to support this theory.

Actually, there have been a number of recent examples of just the opposite: huge losses created by very smart people. In a SmartMoney article (June 2001), by Eleanor Laise entitled “If We’re So Smart, Why Aren’t We Rich?”, the author tells of a MENSA investment club, with very high I.Q. members that produced extremely low returns of +2.5% over the last 15 years in stock investments. Over that same period, the world saw record moves in stocks across the globe.

Long Term Capital had its share of brilliant Nobel Laureates on the board when it leveraged itself into a financial debacle that rocked the stock and bond markets in August of 1998. Losses were so large that a number of the larger prime brokers had to step in to unwind the firm’s positions and help cover some of the losses to help protect the integrity of the financial markets.

Michael Berger, a central figure in the recent Manhattan Fund debacle, where investors lost over $400 million due to ill fated short-sale strategies in a bull market, has been described as extremely knowledgeable, capable and very believable. It took a lot of brilliant thinking to hide these massive losses from investors for as long as he did.

So why do so many intelligent traders lose money in the markets? In my 25 years in the trading business, I’ve seen many very smart people struggle to produce a bottom line. Some of the mistakes that these traders tend to make are:

1. **Not diversifying because they know they’re right.** Smart people know their smart. They’ve made good grades all their life and maybe collected a few scholarships along the way. They’ve got multiple degrees. They can recall obscure pieces of information on many topics. People tell them they’re smart. All of this can go to their head, if they’re not careful. Eventually, they get taught a lesson that they cannot outsmart the market.
2. **Not using a sell strategy**. Smart people know they’ve stacked the odds in their favor and have a done their homework. They don’t believe they can fail. Maybe they’ve never failed at anything significant before in their lives. Who needs a sell strategy when you know you’re right? The market has ways of teaching these people a lesson.
3. **Averaging down in a losing position.** It the investment idea was good before, it’s even a better deal now, because they can buy it cheaper. The market can continue lower beating them up severely and sometimes putting them out of the game.
4. **Thinking that exhaustive, long-term studies of a strategy can predict the future.** Like the disclaimer always says, historical results do not give an indication of future profits. This is actually true and backed up by countless studies of traders across lots of markets, across lots of strategies and across lots of time periods. Smart people sometimes think that, by taking vast sums of data and analyzing it to death, they have an edge in predicting what the market will do next. Blowups can and will occur when the market does something it has never done before.
5. **Over-optimizing a strategy using historical data.** Since smart traders have the mental ability to think up all sorts of ways of trading, they can come up with countless parameter sets in their strategies to trade a historical database with wonderful results. The problem generally becomes that they are fighting the last battle with the markets in their simulations, not

necessarily the next one that they should be concentrating on. They don't give themselves what-if scenarios that might occur and prepare for them properly.

6. **Searching for perfection.** Intelligent traders can come up with so many better ways to potentially trade, they sometimes spend most of their life searching for perfection, rather than trading the best strategy they have at the moment and realizing they can work at making it better over the long run. You'll never have the perfect trading strategy. Just give it the best shot you can each day and never stop trying to make it better.
7. **Frequently changing an existing losing trading strategy to a "better" strategy.** Smart people may have very active minds that can dream up all sorts of new, "better" ways to trade. Some can even be very complicated to satisfy their intellectual firepower. But, if you make the assumption that all strategies have their day in the sun and their day in the dog house, then moving away from a losing strategy may be very foolish. The strategy that looks hot right now, may become very cold down the road and this year's mediocre strategy may become next year's star performer.

So, now that we've discussed how some very intelligent traders fail to make a passing grade at trading school, here are a dozen common sense things that successful traders do to be successful at their craft:

1. **Create and understand the strategy you intend to use in your trading.** If you don't understand why you are doing what you are doing, how can you expect to keep doing it? Buying a black box system of some sort, that advertises some profits is not going to give you the comfort level to stick out a tough drawdown when the markets aren't cooperating with your strategy. Knowing what went into your strategy and why you expect some losses will give you that psychological stomach lining to stay the course on your strategy and enjoy the next period of profitable trading.
2. **Match your strategy to your personality, ability, skills, time commitment and capital to be invested.** Sit down and do an inventory of these things and frequently you'll be well on the way to the approach you should take towards trading. If you're not a computer expert, you may find you either need to develop a strategy that doesn't involve computers or take some computer courses to improve your skill levels in that area. It makes no sense whatsoever to try to trade the way someone else trades. They have their own skill level, abilities, resources and you have yours. By using someone else's trading strategy, you'll be underutilizing some of your skills and resources and be in over your head on others. Actually, I have known some potential traders that have taken a serious inventory of their trading resources and skill and decided they should not be a trader. That's okay.
3. **Eliminate any notion that profits equal good trading.** Good trading is following your strategy and managing your risks. When you are in the act of trading, simple execute the strategic plan. If you executed the plan and took loses that day, you get kudos for your efforts. Executing the plan over the long run will create the profits, not the efforts of a single trade or a single day's trading.
4. **Diversify your portfolio.** Having a concentration in one market or position can be extremely profitable, but it can also knock you out of the game. It's common sense to not put yourself in a position where you cannot come back tomorrow and continue your trading. Simply spreading your risks is a simple way to help reduce the impact of a serious loss of capital.
5. **Concentrate your portfolio.** This suggestion would seem to be at odds with the last suggestion, but it means getting your portfolio down to a size where it can be effective without over diversifying it. Many professional traders, with all the computer firepower have taken to trading hundreds of markets, only to find that a handful of markets create the bulk of their profits. Trading in markets that fit your strategy or that you have an expertise in makes more sense than mindlessly diversifying beyond what you can logically handle.

6. **Watch your leverage.** The more brilliant a trading strategy seems to be, the more the expectation of profits lures traders to leverage it up. After all, why just make X%, when you can make X% times 2 or 3? The answer is that you want to be there tomorrow trading and too much leverage can knock you out of the game, if a few positions go against you. Dial in your trading leverage so that you can tolerate the amount of risk you are taking on and you can make a career of trading.
7. **Take the attitude that gains AND loses are part of the deal.** You can't have one without some of the other. Understand that every strategy will have periods where it absolutely nails the markets and creates nice profits. However, every strategy has its Achilles heel and will struggle at times. This is simple common sense, and yet, how many times do we see investors and traders abandon a trading strategy after a string of losses. Did they really expect to not have some losses?
8. **Make your own decisions on trading.** Believe it or not, a simple, unsophisticated trading decision by you is far better for your trading success than trading a tip from some analyst or industry guru, because you will understand why you did it and can control the risk on the trade according to your strategy. (See number 1) You don't know what went on in the analyst's head when doing the analysis. You don't know what their tolerance of risk is. You might not know whether or not they've got a position in the recommendation. You might not know where or when they will exit the trade. Making your own decisions on trading empowers you to have control of your trading strategy and risk management**.**
9. **Let gains run and cut losses short.** Repeated often in articles like this, but not followed by those who "know" they are smarter than the markets. No matter what the strategy, you have to buy low, sell high, or sell high, buy low in order to produce a profit. I maintain that even spread traders and arb traders are taking a position in the spread or the arb. So, no matter what the strategy, if you don't cut losses short, your account could get severely damaged sometime down the road.
10. **Know where you are getting out of a trade before you get in.** Many investments are "sold" to the client. Some traders get into this same mentality. They think of all the reasons they want to own a position in something, but forget that somewhere along the way they'll need to be out of that position. I recommend setting strategy up front on conditions necessary for you to get out of the position. This could include cutting losses short at some level or taking profits after a trailing stop level is breached. If you don't have an exit strategy, don't put the trade on.
11. **Treat each trade like it's the next trade in a sample of the next 1000 trades.** It's not life or death. It's just another trade. It may seem important at the time, but it's just another data point in the sample of the trades you'll do over your lifetime. Don't make it any more important than that.
12. **If it ain't broke, don't fix it.** So many traders jump from strategy to strategy, never sticking with anything very long. Historical simulations can be useful in helping the trader gain a feel for the volatility of a strategy or some of the ways the strategy reacts to various conditions in the market. All strategies will have periods of lackluster or even losing performance. If this is extraordinarily different from what was expected, time to dig in and determine why. However, if the losses are well within what you should have expected when you started trading the strategy, then suck it up and stay the course.

You don't have to be a brilliant genius to be a good trader. There certainly have been a lot of smart people over the years that have lost vast sums of money. At the same time, there have been many traders that do not have intellectual pedigrees that have made huge profits. All of the suggestions I listed above are things that any trader serious about trading successfully could handle. If you do happen to have the burden of a brilliant mind, be smart enough to realize high I.Q. does not correlate with large trading profits. Trading success comes from sound strategies, excellent risk control, strict discipline and good dose of common sense.

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