

Preface

- His daily bread depends on reversing big moves. His function is to balance supply and demand. Sell when prices are high. Buy when they are low.
- Prefers to draw attention to and accentuate his weaknesses and losses - to keep him humble
- Refutes efficient markets
- Doesn't own a tv, follow the news or talk to anyone during the trading day
- Dislikes reading books < 100 years old
- Losses of 7-8 figures, > 25% of liquid worth and client net assets in a single day
- 2 million contracts traded with average profit of \$70 / contract after slippage
 - 700 standard deviations away from randomness
- Will not share secrets or systems; it's 'inconceivable' that anyone would share a truly effective get-rich scheme for the price of a book
- Better to go against the gurus
- Chess teacher is Art Bisguier - "You have to know the lesson is there in order to use it"

The main part of this book is written like a novel. Neiderhoffer clearly harbours some literary ambitions and decides to mix business with pleasure. He writes with a skill that is rare for a business book writer. In fact the prose is florid, and in some places even poignant. When was the last time a trading book made you cry?

The trouble is you can't be sure if he's being serious (he has a wickedly subtle wit) and if the things that are happening actually happened, or are part of a literary device. I can see why this book never really took its place in the classics of trading literature, as the reader looking for some solid trading advice has to wade through pages of the golden age of ancient Greece, romantic trysts under the boardwalk at Brighton beach, and conversations with ghosts.

The reader who wants a surreal journey through the life of a Wall Street trader (with George Soros and his departed father and grandfather as companions, no less) well, who is that reader? I guess it's me. Probably just me in the entire world, so I doubt this book sold too many copies.

It has good reviews on Amazon, but I sympathize with this annoyed fellow.



Cory Mitchell

★★★★★ **Word Soup**

Reviewed in Canada CA on September 24, 2019

Verified Purchase

A rambling mess of words where little, if any, concrete trading insights are provided.

Helpful

Report abuse

But Cory Mitchell is wrong, because it's choc-a-bloc with trading insights, you just have to work very hard to find them. I will save you the trouble, dear reader; the pleasure is mine.

Chapter 1 - Brighton Beach Training

This first chapter is written in the style of Hemingway, as a stream of consciousness, mixing actual trading thoughts with random daydreams. Here's a sample:

"I love you yen. You are so orderly, so loyal, like your country. I don't hold it against you that you would not take my dollars when I tried to buy food in Tokyo for my family of eleven. Now take my dollars. You feel the gaijin are dirty. They will not take their shoes off in your crowded restaurants. But I do take my shoes off. I'll build a rock garden and sit and pray to Shinto gods if you'll just take my dollars at 93.50 and then go down to 91."

At the same time I find myself relating to a lot of his daily fears. Aging. Thoughts of former coworkers. Loneliness. Lack of sleep. This is very real, despite being written as fiction.

- The wholesale failure of brokerage firms during a panic is often associated with market bottoms
 - Nikkei bottom in 1995 coincides with failure of Barings & co.
 - Jim Rogers bought Pakistan stocks because their stock market was shut down
- The inverse is also true - when brokerage houses are flush with profits, time to sell
- However Neiderhoffer warns that sage advice is easy to give and knowing what to listen to requires experience and principles

Lessons from Livermore

- The only thing a man should do when he is wrong is cease to be wrong
- You can beat the market in grains but not the grain market
- There is the plain fool, who does all the wrong things everywhere, but then there is the Wall St. fool who thinks he must trade all the time
- Their (broker) accounts didn't always agree with mine, and the differences uniformly happened to be against me. Curious coincidence - not!
- If a man didn't make mistakes he'd own the whole world in a month. But if he didn't profit by his mistakes he wouldn't own a blessed thing.

- The mistake family is so large that there is always one of them around when you want to see what you can do in the fool-play line.
- The weaknesses that all men are prone to are fatal to success in speculation. It is inseparable from human nature to hope and to fear. It is absolutely wrong to gamble in stocks the way the average man does.
- The best way to taste (test?) plausible theories is to quantify, test, and analyze them rigorously.
- Niederhoffer (VN from now on) tests the brokerage house theory
 - Collected monthly prices for Merrill Lynch 1972-1995
 - Computed monthly and yearly returns and compared to S&P500
 - Excess returns of ML vs S&P should be an inverse predictor of future S&P moves

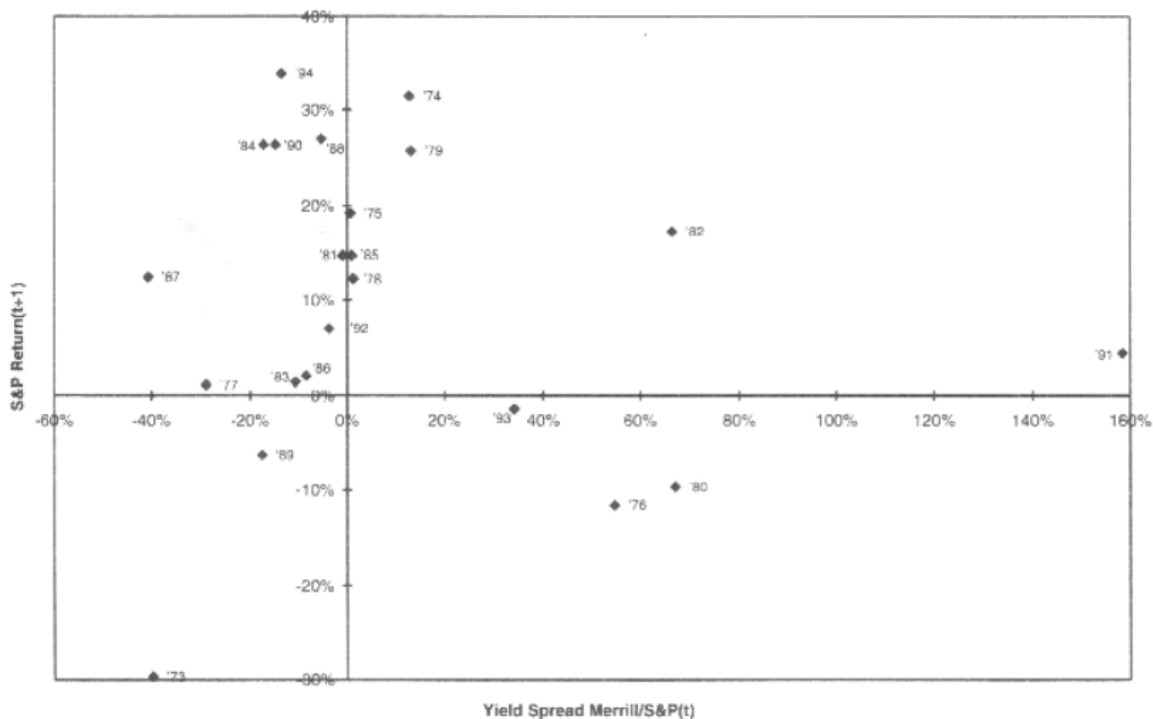


Figure 1-1. Excess Return of Merrill vs. S&P Return (Following Year), 1972-1995

- Unfortunately there is no support for the inverse theory for monthly returns but there may be one for yearly returns (cycles)
- VN has not had one satisfactory day of trading
 - When he makes money he kicks himself for not being more aggressive
 - When he loses he kicks himself for not staying away
- Whitlow Wyatt's rules for staying ahead
 - Never let down for a moment. Pitch to every batter as though you were facing him the first time. That keeps you careful.

- Pitch to every hitter as though you were trying to keep him from getting a long hit
- No matter how low a batter's average may be you can't afford to show him too much of even your Sunday pitch or he'll hit it.
- No phone calls, lunch breaks, or visitors on trading days, no signing checks or filling out forms
- "The more he talks about his honesty, the faster I count my silver."
- "I have never seen a success in any field who didn't have some internal mechanism for economizing on energy at work at all times."
- The Judas steer - the story of the steer who leads his fellows to the slaughter but always manages to escape somehow himself; **the markets also do this - move a few wild ticks in one direction just to induce investors to take a wrong position in stocks.**
 - Tax breaks are usually a sucker's play

Chapter 2 - Panics and Hoodoos

Frequency of Panics, 1890–1996

Decade Beginning	Number of Panics
1890	11
1900	9
1910	7
1920	9
1930	38
1940	4
1950	2
1960	3
1970	9
1980	4
1990–1996	1

BUY AFTER THE PANIC

- Old Wall St. hands know to take out their canes and hobble to the Street after the panics; then they always buy good stocks to the extent of their bank balances

	Move in S&P Next Day		
	Average Points	Percent Up	Occasions
After decline of 7.50 points	1.39	.55	31
After rise of 7.50 points	.88	.60	30
After any day	.12	.52	2164

- Buying after panics in bonds is not such a profitable activity
- Panics have 'all but stopped' in the 1990s says VN
- VN's panic definition is 10 percent and one month

Table 2-2. Chronology of 10 Percent Crashes in Dow Jones Industrials, 1890-1990

Observation	Date of Crash	Price	Price Three Months Later
1	Nov. 10, 1890	62	66
2	May 9, 1893	59	48
3	July 17, 1893	52	51
4	July 26, 1893	43	56
5	Dec. 21, 1895	49	54
6	July 14, 1896	49	49
7	Aug. 6, 1896	44	55
8	Nov. 5, 1897	46	50
9	Feb. 24, 1898	45	52
10	Nov. 13, 1899	64	63
11	Nov. 18, 1899	58	63
12	Jan. 2, 1900	68	66
13	May 15, 1900	57	59
14	July 21, 1903	51	45
15	Sep. 24, 1903	47	48
16	Dec. 12, 1904	66	78
17	Mar. 13, 1907	83	79
18	Aug. 12, 1907	71	57
19	Oct. 11, 1907	64	64
20	Oct. 29, 1907	57	62
21	Jan. 3, 1910	88	85
22	July 22, 1910	70	86
23	Dec. 18, 1916	98	96
24	Sep. 4, 1917	81	71
25	Oct. 31, 1917	75	80
26	Aug. 20, 1919	98	108
27	Nov. 28, 1919	104	91
28	Feb. 4, 1920	97	94

29	Aug. 7, 1920	84	85
30	Nov. 17, 1920	75	76
31	Dec. 22, 1920	67	77
32	June 6, 1921	71	69
33	Mar. 20, 1926	145	153
34	Oct. 3, 1929	330	247
35	Oct. 28, 1929	261	258
36	Oct. 29, 1929	230	262
37	Nov. 13, 1929	199	272
38	May 5, 1930	260	220
39	June 14, 1930	244	240
40	June 18, 1930	219	234
41	Sep. 27, 1930	213	160
42	Oct. 17, 1930	187	163
43	Dec. 16, 1930	158	184
44	Apr. 16, 1931	163	142
45	Apr. 29, 1931	144	136
46	May 29, 1931	128	142
47	July 27, 1931	140	101
48	Sep. 12, 1931	124	79

Table 2-2. (Continued)

Observation	Date of Crash	Price	Price Three Months Later
49	Sep. 21, 1931	111	78
50	Sep. 30, 1931	97	77
51	Nov. 21, 1931	97	83
52	Dec. 4, 1931	87	86
53	Dec. 14, 1931	77	81
54	Feb. 9, 1932	72	57
55	Mar. 31, 1932	73	43
56	Apr. 8, 1932	63	41
57	Apr. 29, 1932	56	53
58	May 25, 1932	49	73
59	July 4, 1932	43	71
60	Oct. 5, 1932	66	62
61	Oct. 9, 1932	58	62
62	Dec. 13, 1932	60	54
63	Feb. 14, 1933	57	81
64	Aug. 4, 1933	93	93
65	Sep. 27, 1933	93	97
66	Oct. 21, 1933	84	106
67	May 10, 1934	94	90
68	July 26, 1934	86	93
69	Sep. 7, 1937	164	128
70	Sep. 25, 1937	147	127
71	Oct. 18, 1937	126	132
72	Nov. 20, 1937	120	128
73	Mar. 23, 1938	114	127
74	Mar. 29, 1938	102	136
75	Mar. 29, 1939	132	130
76	May 14, 1940	128	123
77	May 21, 1940	114	125
78	Feb. 14, 1941	118	117
79	Sep. 3, 1946	179	168

77	Sept. 2, 1948	177	188
80	July 12, 1950	199	229
81	Oct. 22, 1957	420	446
82	Sep. 28, 1960	569	616
83	May 24, 1962	623	616
84	June 21, 1962	550	592
85	May 5, 1970	710	725
86	May 26, 1970	631	760
87	Nov. 14, 1973	870	810
88	July 10, 1974	762	648
89	Aug. 22, 1974	705	615
90	Sep. 13, 1974	627	593
91	Dec. 5, 1974	587	753
92	Nov. 13, 1978	792	830
93	Nov. 6, 1979	806	882
94	Mar. 12, 1980	810	873
95	Feb. 8, 1984	1156	1176
96	Oct. 16, 1987	2247	1956
97	Oct. 19, 1987	1739	1936
98	Aug. 16, 1990	2681	2550

- “Ghosts” or dead ducks - former members of the exchange who lost all their money
 - “They have studied every influence, every feature that had any bearing on the market, and worked them out in detail; and yet with all their determination to succeed they are now numbered among the hapless ghosts of the Street. They have passed the sixty year limit, and must eventually end their days in an East Side lodging house.” - Riggs
- The public is trained to buy before it sells. Most people don’t even understand the mechanism of shorting.
- VN tells this part of the story through the eyes of his grandfather, Martin and his wife, Birdie. Like many married couples, the wife is the better speculator but Martin does all the trading, and usually doesn’t listen to reason.
- Martin liked to sell short the day after a bloodbath. This is a mistake even VN doesn’t make he says
 - He doesn’t like to sell stocks short
 - Brokers have contrived reasons for refusing to pay interest on the credit balances (a bit like [Forex charging negative interest rates on swaps both long and short](#))
 - So VN loses a an interest rate, a dividend, and a risk premium when shorting
 - Soros told him that he lost more money selling short than any other speculative activity
 - Individual shorting of stocks is a ticket to the poorhouse
- Everything changes - the great companies of yesterday become the dogs of today
- VN’s first stock, a bar mitzvah gift, was the cheapest stock on the NYSE -Benguet mining
 - While the Dow rose the stock stayed riveted to 50 cents for four years.

- Then a miracle - it rose to \$1. On his grandfather's advice he sells it for the \$50 profit
 - Then it promptly advances to \$30 in three years.
- Repeatedly VN has made the mistake of grabbing small profits and selling at a targeted round number
- A number of nonrandom phenomena occur around target prices
 - After a break up and subsequent pullback the markets 'tend to be quite bullish'
- "He should have known he was at the mercy of unscrupulous operators. **They always sniff out the players who have gotten in over their heads and crush them like ants underfoot.** Make sure they don't do that to you."
 - 'They' are the collective Jungian unconscious of the market
- A 'hoodoo' - much like a 'ghost' but they offer tips and try to borrow money; they are bad luck
- There are also anti-hoodoos of which VN considers himself one. They make their partners and assistants into millionaires, directly or indirectly.
 - Everyone copies an anti-hoodoo
- His grandfather martin gives him the following advice, implied to be bad
 - Stay with the old standards (blue chips)
 - Don't be deceptive
 - You never go broke taking a profit
 - Stay away from Fridays.
 - Never buy a stock or a bond on Fri. the 13th
 - VN tests this out and discovers actually there is a statistically significant advantage to buying bonds and stocks on Fri. 13th
- VN recommends fading published technical analysis of academic systems
 - He dismisses pairs trading as a fad
 - **Even a professor is shrewd enough to keep the good stuff, if any, private**

Chapter 3 - Delphic Oracles and Science

- Oracles, forecasts and prophecies are a business
 - You should regard them with the same scepticism reserved for used car sales, or rug auctions
- VN compares the Delphic temple to the Federal Reserve
- VN classifies modern forecasters into several 'species'
 - The mystic: uses Fib levels
 - The unappreciated, bitter, angry, lonely: permabears pointing out that some local event is very bearish while the Dow continues to make new highs
 - The Other World Person: doesn't read TV or newspapers; looks at parking lot occupancy
 - The Mathematician: calculus, chaos theory, evolutionary programming; looks at obscure equations to find periodic cycles (LOL a little close to home)

- The Traditionalist: Gann, Livermore or other historical figures; “I spoke with Colonel Roberts, the greatest living expert on Gann-Elliott and he agrees.” LOL!!
- The Washingtonian: worked for the government or attended a conference in Wash. once; his source says the president will resign before the end of his term (60% chance) (These days it's a 60% chance the president won't peaceably give up his term.)
- The Correlation Expert: Soybeans traditionally go into the gutter before a big bond rally
- Stand-Alone Artist: a maverick who can't be bought;
- The Insider: attributes all moves to people like Soros
- Among these VN identifies with the Other World Person
- Browne's lampoon of self-evaluations by forecasters
 - They are always around 87% correct (can you imagine how much money you could make if you had access to 87% accuracy)
 - January's review doesn't actually reproduce last year's forecasts (space limitations)
 - Instead there is a scorecard
 - Some right, some wrong, some inconclusive
 - He cites a couple of forecasts that were especially shrewd (expected)
 - However he also cites some near-misses as 'wrong' and now we are won over by their honesty (LOL!) - said gold high would be 450, but was only 406.
 - His talent and standards tower over yours, obviously
 - “Any man who's wrong only 13% of the time and who's that close when he's wrong, must be a genius.”
 - The truth is he's barely 40% right, he never repeats last year's forecasts accurately and the gold high of 406 was already in when he said the high would be 450-500. So he missed the high by 10-19% and failed to foresee that gold would spend the rest of the year heading downward.¹
- Feynman one month before he died in 1988
 - “It's a game, and it's not serious.”
- A good gamester, good musician, good scientist, and good speculator often turn out to be one and the same
- VN launches into a detailed examination of the scientific method and decides he will make his living by applying the scientific method
- “I was fortunate to find one area for application of this method - an area that had not advanced beyond the scientific techniques of the dark ages, an area where preconceived ideas and logic rather than counting and questioning formed the basis for accumulating knowledge. I found the field of technical analysis of markets.”

¹ One of the most reliable indicators, in my experience, is a forecast that is set in the near future. If you expect that it's already happened and now you should fade this advice it's often much better than 50% accurate. That's because by the time something is noticeable, it's already on its way to correction. Also this pretty much sums up my experience of all forecasters and signal services. Worse than useless, but then also paradoxically useful.

- VN notes that the techniques of bogus scientists and supernaturalists are virtually identical to those deployed by market gurus
 - Appeal to authority
 - Absence of counting
 - Framing of predictions in a form that is untestable
 - Tautological prediction guaranteed to be true under almost all circumstances
 - No allowance for chance variations; no allowance for sampling variation
 - Paranoia
 - Disregard of alternative explanations
 - Self-evaluated accuracy
 - Retrofitted systems
- **Differences observed for many market phenomena are merely due to sampling variations resulting from the large number of samples taken and high variability within the population**
 - Superbowl indicator (chance of correlating any 5 major sports contest outcomes to a 250 point rise in the Dow is ~50%)
 - “Enough practitioners of losing methodologies exist to ensure profits to those aware of their tactics.”
 - Some people think the markets are not random - too many anomalies
 - However, enter **the multiple observances problem**. The more inferences are made, the more likely erroneous inferences become. When you wait for clusters of something to happen you are making potentially millions of implicit comparisons. So you are very likely to find unusual coincidences. VN mentions the Bonferroni correction but doesn’t explain how it works.

Table 3–5. Longest Runs of Consecutive One-Day Changes in Major Financial Markets, 1987–1995

	Up Run		Down Run	
	Number of Days	Date Run Began	Number of Days	Date Run Began
Crude oil	10	Feb. 28, 1988	9	Nov. 9, 1987
Bonds	9	Sep. 8, 1992	13	Apr. 24, 1990
Swiss	9	June 21, 1994	9	Oct. 25, 1993
S&P	10	Jan. 15, 1987	8	Sep. 11, 1991
Yen	12	Feb. 22, 1993	11	Feb. 25, 1992
Deutschemark	11	May 3, 1994	7	June 22, 1993
Gold	8	May 23, 1988	9	Feb. 3, 1988
Soybeans	7	Nov. 9, 1994	7	Aug. 7, 1992

-
- People tend to underestimate how much clustering occurs in random shuffling; The bunching effect

- **Speculators should never engage in casual gambling²**
- Odds of there being the same birthday in a room with more than 23 people = 50/50; the birthday paradox
- Soros and his backaches before a major move against his positions

Chapter 4 - Losses, Comebacks, Trends and the Weather

- Perhaps the best way to achieve victory is to master all the rules for disaster and then concentrate on avoiding them
- “Always make friends with the ref; it can’t do you any harm, and it may help in that he may not go out of his way to hurt you.”
- VN follows this in his dealings with the commodities exchanges

How to Lose

- Know that you are the greatest, winning is a foregone conclusion; let your opponent know that; tell your broker how much you like a particular trade and how well you’ve been trading lately
- Insult the referee’s motives; write letters to the IRS objecting to the level of regulation imposed
- Cut your gains when you’re ahead; never think about what could go wrong; grab small profits, refuse to take losses
- When behind, put everything into catching up; after catching up, coast for a while and give yourself some well-deserved praise; dwell on past victories; never look at defeats trying to figure out what you did wrong; don’t learn from traders who have poor results; losses are just bad luck
- Let the market know your intentions; leave limits and stops with the broker at round numbers
- Don’t worry about Fed announcements or activities
- When the market goes your way, get out immediately and think about what to do next
- When trading, invite your significant other to come by and see you in action; if you’ve got it, flaunt it!
- Take a break with a paramour in the middle of the trading day
- Apply systems without paper trading
- Attend to other business while trading; trade around positions during breaks
- Make enough money trading each day to cover one special purchase
- Stick to your guns if the market moves against you, gains are bound to come back when the market is wrong

² I believe this too

- Celebrate victory the evening before; tally your profits in a trade; don't get less than your due; don't even show up for trading just leave an order with your broker to exit at the close
- Don't worry about your fills, what's a tick or two going to matter?
- There are 1M others, in poker, sports, gambling or speculation, losing is easy

Lessons from VN's losses

- Don't get in over your head
- Political events are unpredictable, especially when the market is on a tear
- Information that seems to be completely fresh is often as smelly as a dead fish (what you think is news may be widely know by insiders by the time you hear about it)
- Never use stop losses. Invariably price moves to the level of the stop. They are tools to reduce your broker's risk, not yours.
- Never be flippant, especially when forces are with you
- After a loss, victory becomes more likely (**but isn't this the gambler's fallacy?**)
 - VN is saying that after a loss your will to win can become sharper
 - He cites quotes from René Lacoste (tennis) and J.R. Capablanca (chess) about how losing is a learning experience, and sharpens willpower
 - **All great champions are humble; the same is true for speculators**
- The danger of hyping your performance is you might come to believe it after the fact
- VN never heard Soros talk about a winning trade despite working for him for 10 years
- After a loss markets generally become more bullish
 - The average change for the worst performing commodity market in the next year is 20.2%, a good return over the usual 5%
- **The most dangerous time is when you're ahead**
- Why fight the trend; why make it hard on yourself; Markets are reflexive, positive feedback, You're only as good as your last trade - all from Soros

Price Action

- Taussig found 'penumbras' of price oscillation - what later became known as 'support and resistance'
- Cootner tried to merge the penumbra with the random walk
 - Price behave as a random walk with reflecting barriers
- VN has extensively studied the phenomena of price reversals and breakouts
 - Studied principles of music, nature, deception, gambling, games
 - Speculation is an art-science
 - Price sometimes moves like a wild beast, a gentle lamb, or a playful trout³
- Buy grains after a volcanic eruption

³ He's being facetious but this is shades of Mandelbrot's 'mild, slow and wild' randomness types.

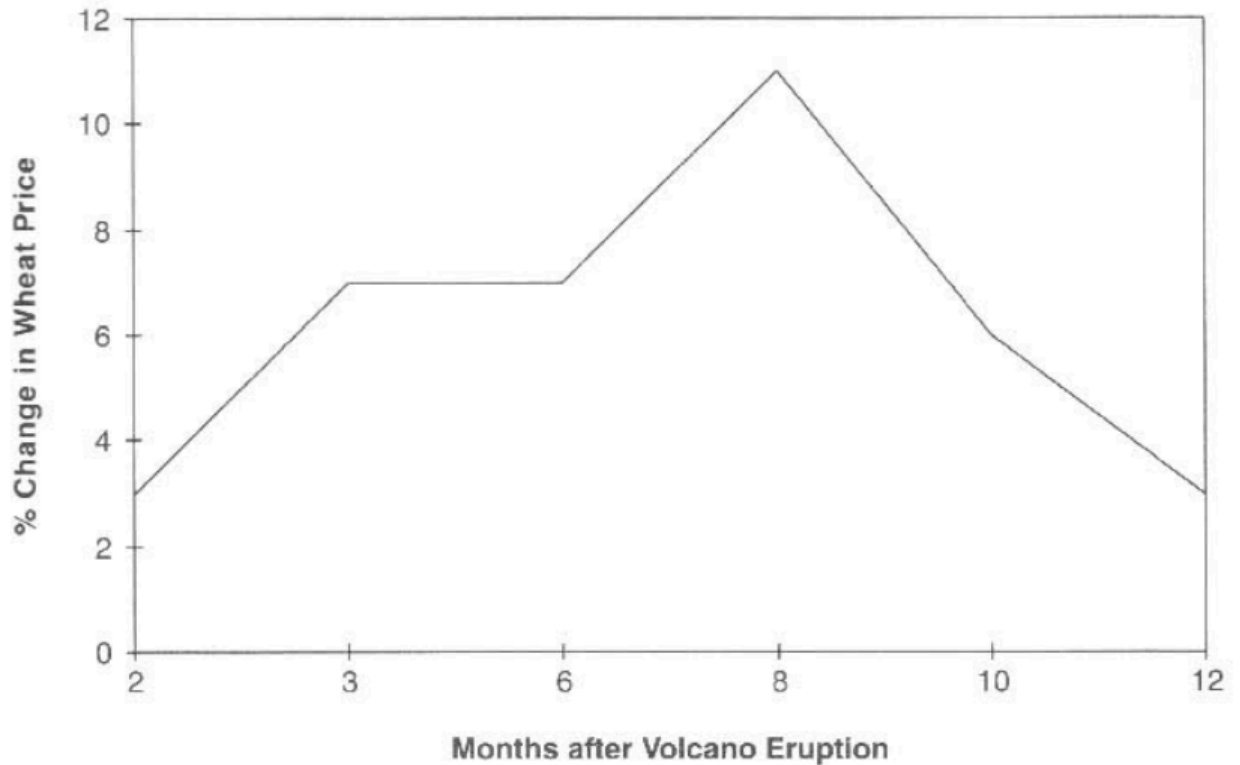


Figure 4-1. The Volcano Eruption/Wheat Price Relationship

Undergraduate thesis

- VN's idea which he describes as 'naive' is that two consecutive price rises accompanied by two consecutive volume increases = positive breakthrough; the opposite is a negative breakthrough. Price is more likely to rise on the latter.
- He tests stock prices from 1928-1961 and believes he has disproved the random walk theory, or at least put the burden of proof on showing there is randomness
- However the theory doesn't hold up when testing the data from 1946-1991
- However he says he has been testing the theory that price moves can be predicted using the trading room as a laboratory

Congestion of Prices

- Certain members of exchanges have the exclusive license to make markets in stocks - they are called specialists (recall Sperandeo)
- Specialists have traditionally been the most profitable denizens of Wall St.
- Limit orders are given to specialists and this creates congestions of orders at prices that are multiples of 5 or $2\frac{1}{2}$ and multiples of $\frac{1}{4}$ in the lower cap stocks (less than \$10/share).
- Buy market orders are executed at the price where sell limit orders are concentrated.
- Sell market orders are executed at the price where buy limit orders are clustered.

- If there are buy limits at $99 \frac{1}{2}$ and sell limits at 100, the price will fluctuate between $99 \frac{1}{2}$ and 100.⁴ This creates opportunities for fast-moving professionals.
- Limit orders act as barriers to short-term price movement
- Shrewd pro traders, limit order-users, market makers are all reversal creators
- Strong underlying demand or supply cause predominance of continuations (trend)

Chapter 5 - Winning and Self-Reliance

- VN waxes philosophical on the value of self-confidence; all you need to know is that's good to have
- Being around books is a good way to gain knowledge (worked for me, maybe, but my kids, I'm not so sure. If YouTube shorts are a way to gain knowledge they will be geniuses)
- What's good for everyone else isn't necessarily good for us
 - “For crying out loud—you're like a zombie in front of that TV set [at my grandparents' house]. Look at you. You're in a trance. TV may stimulate you, but it makes you passive. You're poor. You're not going to have the luxury of having others do things for you. Remember that. If you want something to happen, you're going to have to do it yourself.”
 - “But I need it for my homework,” I'd say. No dice.
 - This is almost word-for-word what I'd say to my kids, but sub 'laptop' for 'TV'. The response is also the same.
- VN likes to go for a walk in the woods, unfortunately that's usually when the markets like to make a move
- On math tests: the answer is likely to be 1, pi or e. If that doesn't work try the perpendicular to the base.
- **It's amazing how often simple guesses tend to be accurate (Blink - Gladwell's 'thin-slicing')**
 - Where will a stock be at the end of the year? - most likely unchanged
 - If a commodity has a big move at the start of the week, the best guess for the second half - the opposite
 - NYSE daily unchanged issues - 2%, much higher than chance
 - Close at the same price - excessively common
 - Take advantage of this by selling at the money option straddles
 - Sell a call and a put at the current price
 - Make money on both sides when it expires at the same price you sold it
- The market shares VN's love of unchanged issues
 - In a day 3100 issues are traded on the NYSE
 - 725 or $\frac{1}{4}$ show no change for the day

⁴ I've had this idea too where you could check to see where the average long and short position levels are and see if price moves back and forth between them, but it didn't seem to pan out. Maybe I should revisit it?

- 10 days a year 15% of issues go unchanged
- 10 days a year when percentage of unchange stocks is 30% or more the market is bullish over the next 12 months, going up 10 percentage points a year above norm
- Never sell a quiet market
- FX - the NY range is often == the range in Tokyo and Europe
- MFM Osborne vs. Oskar Morgenstern; VN says Osborne wins⁵

Moves in S&P Following Small and Large Daily Changes*

Greater Than	Less Than	Description of Move	Number of Observations	Average Change Next Day	Average Change Next Five Days
0	1.00	Small rise	354	.16	.37
-1.00	0	Small decline	347	-.10	.83
1.00	2.00	Medium rise	260	.09	.13
-2.00	-1.00	Medium decline	227	.12	.70
2.00	3.00	Large rise	185	-.14	.18
-3.00	-2.00	Large decline	140	.27	.67
3.00	4.00	Substantial rise	118	.09	.42
-4.00	-3.00	Substantial decline	102	-.13	.17
4.00	5.00	Steep rise	80	-.04	.63
-5.00	-4.00	Steep decline	60	.68	2.75
5.00	∞	Tremendous rise	106	.76	1.05
-∞	-5.00	Tremendous decline	92	.37	2.91

*Average close-to-close changes in S&P Futures Contract from 1988-1996, following daily changes of indicated magnitude. A change of 1.00 point in the S&P corresponds to eight points in the DJIA.

It was studies like this that drew me to Niederhoffer in the first place. Something so simple and easy to prove should be important - and infallible right? Alas, maybe not.

- After a small positive change (less than 1.00) the average move the next day is close to zero
- Same for negative changes
- There are more large positive than negative changes which refutes the notion that declines are more violent than rises

Harvard

- A fun chapter with little to do with markets or economics but
- “Grade inflation, egalitarian marking, numerous pass/fail courses all have made most grade-point averages as meaningful as the lines on a stock chart.” Tells us that VN has little truck with charts or academics.

⁵ He would say that as [they collaborated on a paper together](#) that was reviewed earlier in the book club. You remember that, surely. 😊

- VN games the system as he realizes the minimum grade for an undergraduate class is a B+. So he takes only graduate classes and doesn't study.
- This technique allows him to come in 2nd out of 150 econ majors and becomes known as "Neiderhoffer"
- Years later one of his former professors says, "Here you are Neiderhoffer the commodity markets by picking up the detritus of Soros's trades, just as you did in my classes."
- Similar tales like this makes it seem like Harvard was a cakewalk back in the 60s, **which it probably was.**
- Rules for the market derived from rules for test-taking⁶
 - Go with the market at the beginning of a period
 - Go against it near the close
 - When in doubt stay out
 - Spend time trading liquid markets about which you have superior insight
 - Forget about the markets that are followed by 200 analysts
- The urge to get even is one of the most costly habits of speculators
 - It happens most often after a 'disastrous move'
 - This is why when prices manage to come back after a huge move they're ready to go much further
 - A speculator could 'make a fortune quantifying this tendency'.
- Market rises tend to take the shape of a 'U'.
- Declines generally have the shape of an inverted 'V'; occurring spontaneously and quickly and offering little time to get on board.
- However VN admits he can't back this up with any evidence.
- The best opportunities emerge out of the blue and are gone in an instant.
- If you need lengthy prep just to get your orders in you can't compete with faster competitors (**or robots!**)

Use your [butt]

- Jack, the squash coach, tells VN to use his bum to mislead opponents. By moving it more than usual it makes it seem like he's teeing up for a big swing but he ends up going the other way.
- In the same way, the market sets up players to pick the wrong side
 - Six days in a row, the market opens down, and closes down on the day
 - The seventh day, it twists its bum, and goes up; players jump in to buy, thinking it will keep rising
 - Instead it ends the day down
 - The next time it twists its bum and opens up again, but this time it has a 'wide day' and closes limit up

⁶ If you are a college student or test-taker you should read this chapter

Chapter 6 - The Nature of Games

- The Sharpe Ratio - measures reward per unit of risk
- VN says he 'frequently' racks up 12 consecutive winning months before 'reaping the whirlwind of a disastrous decline'⁷

Disaster lies in the middle

- The bulk of risky transactions is conducted through middlemen - in trading its asset allocators and trading managers
 - They charge 2-4 % of assets per year and relieve the customer of making the ultimate decision
 - They choose the advisors who also charge fees
 - After all these fees, what's left over?
- **Humans like the comfort of a herd in choosing risky investments**
- Diversification of a fund's holding, certification of the fund's size, rating and past performance remove the perceived risk of investment
- A desire to stay in the middle afflicts most speculators
 - VN admits he's too scared to buy something at market when it goes straight down
 - Too frightened to sell it when it goes straight up
 - After it has retraced part of the move, 'he's all too ready'
 - He 'compromises' by leaving a limit order in below the market when it's crashing but this is the worst strategy of all
 - 'Half the time I get filled I can count on an immediate drubbing as trend followers, and other dynamic hedgers jump in'
- VN has a high regard for Francis Galton - the mathematician who coined 'wisdom of crowds'
 - He studied herding behaviour in oxen
 - "Incapability of relying on oneself and faith in others are precisely the conditions that compel brutes to live in herds"
 - "The vast majority of persons have a natural tendency to shrink from the responsibility of standing and acting alone. They exalt the vox populi even when they know it to be the utterance of a mob of nobodies"⁸
- Trading from the middle is the surest ticket to disaster
- **Faint heart never won fortune or the fair lady**
- When the central banks are out to get him, he tries to wait until someone with inside info takes profits then he 'strikes out' to escape his 'pursuers'. In the evenings these are usually the BoJ, the BoE and the Bundesbank
- "You can't outgun them but you can make them fear you"
- VN compares his situation to the Titanic. He relives the noble deaths of Guggenheim, et al.

⁷ Spoiler alert; VN publicly blew up two high profile hedge funds, a decade apart; it's maybe what he's best known for. So what use trading advice? https://en.wikipedia.org/wiki/Victor_Niederhoffer

⁸ He sounds like a bit of a dick! Genius. But Evil?

Seize the Moment

- One of his biggest 'coups' happens when he learns the cost of office rental space per square foot in Bombay (Mumbai) was 10x the cost of New York. Yet its stock market was valued at ½ the level, relatively speaking. He buys the Indian stock market with abandon.
- He saves his skin while short silver during the Hunt bros. cornering of the market by buying the spot month up \$1 on the day and then 'switching' out of his shorts by selling the spot and buying the forward.
 - Of course, immediately after doing so, a rumour that the Hunts were selling causes a reversal; despite this he figures covering at \$11/oz was the right move

Chains

- A good speculator builds his position from a single base linked to a long, flexible chain of trades
- If you're short dollar; buy marks, German stocks will benefit so buy those; pressure will be put on pound and lira, sell those; and their stock; and bond markets; the support system might entangle (??) so sell the peso and sell Indian global depository receipts, calls on Telemex and CBOE.
 - But if the Bundesbank thinks the dollar is overvalued? Your chain will break at its base with lethal consequences
- The market is always mixing up the patterns; " only the utmost attention to the principle of ever-changing cycles enables you to stay on the mixer."
- VN points out that 'rogue traders' are really just bad traders who lost their firms lots of money

Rogue Traders			
Name	Amount	Instrument	Institution
Nicholas Leeson	\$1.4 billion	Nikkei	Barings
Toshihide Iguchi	1.1 billion	T-bonds	Daiwa
Robert Citron	2 billion	Bonds	Orange County
David Askin	500 million	Mortgages	Granite Fund
Metallgesellschaft	1 billion	Crude oil calendar spreads	Metallgesellschaft
Joe Jett	1 billion	Mortgage-backed securities	Kidder Peabody
Juan Pablo Davila	1 billion	Copper	Chilean Government
Victor Gomez	70 million	Mexican peso	Chemical Bank
Jay Goldinger	100 billion	Bonds	Capital Insight
Yasuo Hamanaka	2.6 billion	Copper	Sumitomo

- Endowment effect - no loss is as horrible as giving back what you've won
 - No victory is as satisfying as coming back from the grave
 - When you own something you need more than the purchase price to induce you to give it back; but before you bought it you were on the fence

- Clients were angry when VN made 150% in 15 months but lost 20% in one day
 - But he was golden after losing 30% in one day and ending the month down only 5%

Animal Instinct

- As in the animal kingdom, we learn from play
- Karl Sigmund - life is like a game consisting of gambling payoffs and tradeoffs
- Games help us come to grips with the world
- Gamer's goal is to reach a standard of excellence; as required by life
- Updike - Golf is life and life is lessons.
- In 1995 VN figured big moves in currencies were becoming more common

Table 6-2. The Sixteen Patterns of Life

Biological Pattern	Speculative Pattern
1. Life builds from the bottom up.	Learn about the market-making process.
2. Life assembles itself into chains.	Stocks-currencies-bonds-grains.
3. Life needs an inside and an outside.	The dealers versus the public.
4. Life uses a few themes to generate many variations.	Every day starts with one of the four patterns: up yesterday, up open; up yesterday, down open; down yesterday, up open; down yesterday, down open.
5. Life organizes with information.	Prices provide the information.
6. Life encourages variety by reshuffling information.	Everyday Mr. Market reshuffles his various themes to extract the maximum amount of energy from his opponents.
7. Life creates with mistakes.	Those figures reported today will be revised downward next month.
8. Life occurs in water.	Don't buy stocks when it's snowing.
9. Life runs on sugar.	The public provides the juice.
10. Life works in cycles.	The full moon is inordinately associated with extremes in markets.
11. Life recycles everything it uses.	After they weaken you, the vultures will send your chips back to the dealers and large hedge funds.
12. Life maintains itself by turnover.	The public must have hope, so they return and tell their friends to join.
13. Life tends to optimize rather than maximize.	Speculation is an intricate dance between risk and reward.

14. Life is opportunistic.	Flexibility and alertness will enable you to discover the penicillin or rubber in speculation.
15. Life competes within a cooperative framework.	The dealers need the speculators who need the floor traders. When you lose, be happy you did your job. Just like the 999,999 sperm that don't get to fertilize the egg.
16. Life is interconnected and interdependent.	Only connect the bonds, stocks, currencies, grains, and metals, and you have it made.

Chapter 7 - Essential Board Games

- VN claims that George Soros beat Art Bisguier (a GM) in chess at least twice. (Very suspicious. Maybe with piece odds?)
- VN claims that learning checkers before chess prevented him from mastering chess. (Um..yeah...me too!)
- Buying and holding is great for stocks; not great for futures
- Soros: "Victor, if I can stay close to even when the door is closed, and come in for checkmate when the door is open, I'm delighted."
- Marry a woman who understands your profession

Tom Wiswell's proverbs

- A former checkers champion who starts teaching VN private lessons at his office
- He writes, if we can believe it, 10,000-15,000 little 'tips' or proverbs on playing checkers, but not specifically checkers - any game and even life.
- You can read a bunch of them at VN's website <https://dailyspeculations.com/Letter/wiswell.htm> Those are not in the order that they are presented in the book nor are they identical; in fact it seems these are entirely different!
- Moves that disturb your position the least, disturb your opponent the most
- The importance of little and lowly things - waiting moves, quiet moves, the correct decision between two choices
- To be certain of your position you must begin by doubting it
 - When you are too comfortable in a position - exit it
 - Anything can happen
- A string of good trades can lead to inattention to detail
- A draw is a win for both players since they each avoided defeat
- The clock is your enemy but can become your friend with discipline, mental agility, visualization and nerves of steel
- You can't have two moves but you can have second thoughts

- Play is in a constant state of flux; moves that were thought to draw are now known to lose and moves that were thought to win are now known to draw
- Save deep calculation for the endgame when it's easier to see far ahead
- The losing genie can't easily be put back in the bottle
- Not every day is a winning day but we may not like it.
- Most of the masters and experts have their own grapevine and spies to keep track of the latest play and promising contenders
- Few players reach the top alone
- This goes on for pages, I've already curated this a bunch but I think you'll have to read the book to get the whole benefit; besides, if you don't actually play checkers or chess (at a semi-competitive level) you won't viscerally understand. You'll think you do, but you don't.

Chapter 8 - Gambling the Vig

- Speculation, Investing and gambling are all close cousins, says VN
 - The main difference is that the risk in gambling is created by the casino for entertainment
 - The risk in speculation is inherent, allowing for transference of risk, as well as price discovery, balancing what's desired against what's available in quantity, quality and time
- VN's father, Artie, warns him that **gamblers die degenerate and broke**. He warns him off playing money games of handball
- His wife always asks him - why not sell half? when he's holding a big losing position
 - He never does because he's afraid there will be a big rise after he sells⁹ (of course there will be - doesn't he know about order flow?)
- This follows a few stomach-churning cautionary tales about problem gamblers who ruined their lives
- The house take
 - Often no one at the table walks away a winner
 - The house take of 2-5% a pot adds up when 40 hands are played in an hour
 - The take is small and the house is adept at diverting the chips so that most players don't notice
 - Brokers in low-priced stocks, *ibid*.
 - The spread in stocks can amount to 2x commissions
 - Derivative markets will have no problem quoting spreads with an implicit house take of 25%; in contrast 0.3-0.4% is standard.
 - There is no single price for the public in stocks
 - The bid/ask spread of ¼ on a \$10 stock on NASDAQ comes to 2.5%
 - A turnover of 4x a year erases the 10 percent secular annual trend that favours stock markets

⁹ Was this his Achilles heel?

- A typical bid/ask spread in futures like silver or soybeans is ½ cent on a \$5 item which is 0.1 %
 - For bonds the spread is 0.03 percent
 - This makes it seem like small hurdles to overcome compared to stocks but combined with commissions and bad execution it 'quickly adds up to a staggering load'
- Consider a coin-flipping game (**every trading book needs at least one!**)
 - Heads you win \$1
 - Tails you lose \$1
 - But on every toss the broker takes out 20 cents
 - What are the chances of ending up a winner after 200 tosses?
 - 1 out of 10,000!
 - 20cents per 1\$ is probably an underestimate of the house vig in all but recent years
 - Commissions were \$100 to \$50 not long ago
 - Even with declining commissions the the outcome hasn't significantly changed
 - **The high vig relative to average variation will gradually grind down the public**
 - As bad as this all is, it gets worse because leverage sometimes finishes the job that the vig starts

A typical example

- Joe Public has \$2000 to lose
- He puts up \$1000 to control a future with a face value of \$50,000 fluctuating \$400 per day
- The fluctuation is 400/2000 or 20% of the bankroll
- A very small move against Joe of 3 average daily closes in a row, or one daily move 3x that size is enough to cause a 100 percent loss of margin and 50% of the bankroll
- **Gambler's Ruin makes it almost impossible for the average public speculator to stay in the game, even if he can overcome a 20% house take**
- **The public loses to vig and leverage**
 - VN estimates leverage does the job 20% of the time, and the vig, 80% of the time

Table 8–1. Average Daily Price Changes (Close to Close) 1994–1996

	Dollars	Percent of Change (Average Absolute)
Bonds	\$ 500	0.47
S&P	1250	0.36
Deutschemark	400	0.21
Swiss franc	550	0.36
Yen	675	0.49
Pound	350	0.36
Gold	140	0.35
Silver	300	1.20
Copper	310	1.42
Crude	220	0.96
Heating oil	269	0.97
Unleaded gas	290	1.12
Soybeans	250	0.60
Corn	125	0.80
Sugar	157	1.24

-
- If the public avoided unfair bets it would be the end of gambling houses, insurance businesses and the markets
- **The fundamental problem of speculation - when to go for it based on edge and variability, considering the size of the initial stake, the odds, and when to stop**

The Monte Carlo vacationer

- A man used to go to Monte Carlo was successful each year in recovering the cost of his vacations
- He believed he had a magic power over chance
- Assuming he had 10x the amount of money that he wins each year
- This gives him chances of succeeding of about 0.9 each year. (how this is calculated would be good to know)
- The chance of an unbroken string of 10 successes is 0.37 (actually 0.3487) which is not improbable
- One failure would simply be blamed on an oversight or momentary indisposition (how many traders think they were uncharacteristically careless when they really just had a built-in 0.1 chance of ruin in their system? Just one more reason to appreciate algo trading because it removes any doubt about what is to blame for failure.)

The Classic Gambler's Ruin Problem

- Applies to all speculative situations

- Initial capital is C
- Casino game pays \$1.00 each play with probability P
- Loses \$1.00 with probability Q.
- $Q = 1-P$
- The gambler plans to stay in the game until his capital appreciates to A or depreciates to ruin at zero.
- The speculator's risk of ruin is:

$$\frac{(Q/P)^A - (Q/P)^C}{(Q/P)^A - 1}$$

- Plug numbers into this formula
 - 60 percent chance of winning
 - $1-0.6 = 0.4$ or 40% chance losing
 - Starts with \$1.00
 - Aims for \$10
 - $(40/60)^{10} - (40/60)^1 / [(40/60)^{10} - 1] = (2/3)^{10} - (2/3) / [(2/3)^{10} - 1] = 66.1\%$ chance of ruin for the session
 - That's also a 33.9% chance of finishing with \$10
 - $0.339 \times 10 = \$3.39$ final bankroll but don't forget to deduct the dollar you started with (but why? Isn't this a \$10 gain irrespective of starting capital?)
 - $3.39 - \$1.00 = \2.39 expected payoff
- Now try changing the size of the initial bankroll

Table 8-2. A Gambler's Expected Gain

Probability	Capital								
	\$1.00	\$2.00	\$3.00	\$4.00	\$5.00	\$6.00	\$7.00	\$8.00	\$9.00
100%	\$9.00	\$8.00	\$7.00	\$6.00	\$5.00	\$4.00	\$3.00	\$2.00	\$1.00
90%	7.89	7.88	6.99	6.00	5.00	4.00	3.00	2.00	1.00
80%	6.50	7.38	6.84	5.96	4.99	4.00	3.00	2.00	1.00
70%	4.72	6.16	6.21	5.66	4.86	3.94	2.98	1.99	1.00
60%	2.39	3.65	4.16	4.17	3.84	3.28	2.58	1.78	0.91

- Math is powerful - notice that the max expected payoff tapers off with any bankroll larger than \$4.00. That's because the decreased risk of ruin is offset by the diminished benefit of winning the \$10 max gain.
- With \$9 your ruination is rare, but the upside is only a \$1 gain (to be fair though I would have expected the gain to be \$19, not \$1; but I suppose we need a different formula then - something more like Kelly's formula)
- The point is clear though - the speculator wants to bet lightly enough relative to his capital to fend off gambler's ruin, but heavily enough to make his desired rate of return
- **Unfortunately the real-life speculator doesn't know his true odds of winning on each trade; soe he can't look up the optimum betting levels in a table/formula**

- A player with an edge should bet small, grinding out a profit
- A player with a <50% chance of success (no edge) should bet the maximum because that's the only way he can win and avoid ruin (but also, even better, don't bet at all!)
 - That's why casinos have house limits
 - And exchanges have position limits on what the public can hold (but they'll say it's for your own protection!)
- **Gambler's ruin, house take, and leverage combine to make the chances of winning negligible**
- Price tends to move inexorably to a 'ruin point' within the trading day, only to bounce right back once the traders get tapped out
- VN has trouble getting his friend to realize that **it didn't matter whether he bought or sold silver, he was sure to be a loser regardless.**
- **Balancing initial capital, the size of the spec position, in relation to the size of the edge, the variability of price, is the central problematic equation of speculation**
- In poker, it's adjusting the size of your bets to your stakes, skill and opponents
- A small edge against on each trade leads to certain loss in the long-term (50+ trades)
- **Keeping transactions low, and reducing the house take to a minimum increases chances of survival**
- The house edge in a typical options trade ranges from 12 to 50%; even worse than the zero % chance of winning in American roulette
- Life can be seen as a series of speculations, finding a date, job, deciding when to retire
- The same six variables are at play
 - Initial capital
 - Commitment size
 - House edge
 - Variability of play
 - Quitting point
 - Duration

The road to riches is paved with bodies

- Gamblers may have a deep-rooted psychological need to lose
- Sometimes VN will relax his personal rule about no visitors allowed during trading hours, if a friend is leaving town early; invariably that person will ask to participate in 1% of his action for the day
- Flashing lights/prices bring out the gambler in people
- Some speculators are on an inexorable journey to ruin and everyone can see it (hoodoos on arrival?)
 - VN's story about his friend's brother
 - After 1987's crash he convinced himself it was a repeat of 1929 and there would be a deluge after the rally¹⁰
 - Sells S&P futures and loses heavily on 12 consecutive trades, decimating his equity

¹⁰ This type of thinking is probably what caused the sharp and unremitting rally

- VN suggests index puts instead of shorting futures; then the only risk is premiums risk instead of infinite risk of futures
- He tries this and loses six more times
- VN suggests he take a break from trading; “the market will be there when you get back and your thinking will be clearer when you’re not involved”
- He rejects this advice because something big might happen while he’s away
- The sugar trader who committed suicide
 - He bought sugar below 5 cents and sold above 8 cents. Then one move sent sugar up to 40 cents, a 30x loss on margin.
- Wm Worthington Fowler
 - the losers on Wall St. regret what they might have made and didn’t, more than what they actually lost.
 - Speculators can become obsessive - the optimum (opium?) eaters of finance
 - Speculating is like strong brandy compared to the weak claret of an ordinary business
 - They lose health, character, heart and life, not just money
 - They arrive with money, credit, reputation, hope, strength, confidence, and leave without money, credit, reputation; with shattered nerves, blunted senses, seared consciences, faith in mankind destroyed, hopes crushed by despair
 - The field has never been so dangerous (19??) with stocks watered by as much as 5x the amount represented eight years earlier (what is it now? 800x?)
- VN points out now many stocks don’t even have earnings to water down; only debt
- Shorting stocks is a gamble with a house take of 3% or more, and 10% a year going against, with 50% variability. No way he can end up a winner, says VN.¹¹
- Ratings services of hedge funds that specialize in shorting periodically show their returns at something like -20% a year but this doesn’t factor in the ones that went belly up (survival bias)
- The body’s response has great survival value
- VN compares his championship squash game to Omar Sharif
 - Sharif made more errors in a game than VN would make in a whole match
 - But while VN was conservative and careful, Sharif was willing to take chances
 - VN admits he can never be a Soros; **to go for broke takes the instinct of a professional gambler;**
 - “It takes courage to be a pig” - Stanley Druckenmiller
- All pro gamblers eventually go bankrupt because of their willingness to throw down every last chip¹²
 - ‘Proposition’ bets are usually pre-arranged by the proposer so beware!
 - Johnny Moss (famous for his 5-month long game vs Nick the Greek) lost all his money at the poker table on his wedding night and staked his wife’s wedding ring in order to win the pot.

¹¹ and yet there are shorting specialists like Laurence Bernut who claim to be successful

¹² In the end, isn’t this what happened to him? Twice!?

- VN claims he lost \$2000 in a game at Harvard and his dad had to drive up to bail him out, forking over the family's life savings directly to the kids who won it
- Poker theory has more practical value for the speculator than the study of statistical distributions with infinite variances
- After losing \$5k in a game where he has to borrow money from his wife he quits gambling (poker at least)

Lessons from Poker

- Trade with a reserve equal to at least five times your margin
- Don't trade around funerals or after a fight with a spouse
- Think about gambler's ruin. Any one trade or series of trades can go badly astray. Make sure your stake and backers are big enough to withstand it. Before increasing volatility of returns, be sure you have the capital to handle swings.
- The market will always be there. Wait for a good opportunity.
- Don't trade just for the sake of trading.
- Trouble comes in bundles. Especially if your counterparts smell blood.
- Go for the jugular when you have a winning position.
- Let your broker make a decent profit for small trades. Accept quotes for small amounts even when you don't have an edge. This will improve 'liquidity and opaqueness for when you will need them.' (?)
- Downplay wins. Emphasize losses.
- Who's paying for the yachts? The suckers.
- Consider reversing big up openings and buying small up openings.
- When the market goes up in the few minutes before an announcement, be careful about selling.
- When the market has its largest open of the last six months (for ex. Yen 150)¹³ it's probably not a bluff and should not be reversed
- Don't share trading strategies with friends. Your broker doesn't have to know how smart you are.
- Close out positions at a loss quickly.
- Don't call your broker for quotes. It gives away your hand.
- Trade aggressively when you have an edge, even if it's small.
- If you are in a position that you would like to be out of or that is moving against you, it is often to your advantage to double up. This trade might encourage others to come in with you and allow you to get a better price (surely not applicable to retail)
- Don't stay with a position unless you're willing to stay with it longer than expected in the event of an adverse move in the near term
- Don't try to muscle the market before an announcement. People are already playing it 'close to the vest'

¹³ Amazingly, the yen recent high was 150. It seems the yen has been in the same range for decades?

Deception is best used against one player in a small or medium pot. In large pots, no one can be bluffed. In multiparty pots, not everyone can be bluffed. And it only takes one to catch you.

-
- When your position is going your way, don't get out thinking you will get in later at a better level. Your cleverness will often prevent you from taking the profit.
- When you get an unexpected bonanza, take profits at the close.
- Don't waste energy spending time on other pursuits during the trading day (but it's so damn boring!)
- During periods of extreme volatility, or prior to economic announcements, trade only if you have very strong reasons and can hold through an adverse initial move.
- Some trades work better in liquid markets. Others when there's only one open.
 - When bonds are open and stocks are closed you don't have to worry about a crash scenario
- During calm periods, trade aggressively if you have a solid edge.
- When the explicit news announcements are negative for your position yet it goes in your favour anyway, trade aggressively.
- If you have an edge any individual trade doesn't matter; trade with your edge
- Minimum depth of thinking in markets:
 - What is the effect of an announcement?
 - What is the expected number?
 - What is the anticipated reaction to above or below?
 - Was it discounted or leaked?¹⁴
- Give yourself multiple ways to win a trade
 - For ex. Get out if it's up either the next 2 days or the next week
- Let your counterparties think you're a fish who always loses, but with incredibly deep sources of capital; that way they'll be encouraged to reach to take your trades directly rather than marking them up and brokering them to another player (This could only work if you had for example, known connections with George Soros, surely)
- VN recommends a book by someone named Bacon. A racetrack bettor. Even better, his website has some extracts. <https://dailyspeculations.com/Letter/cycles.html>¹⁵
- "how long can one man be ahead of the pack? Be a man for all seasons?" (my research says, not very long¹⁶)

¹⁴ I think VN is not doing himself justice here as the poker example is more useful. "What do I think my opponent has? What does he think I have? What does he think I think he has? This is minimum" This is third-order thinking!

¹⁵ You should really read it. It's not too many words and it says important things. Things that I thought only I knew. Of course, nothing new is under the sun. It was probably known a century before Bacon.

¹⁶ One exception is Sergi Sanchez who has managed to stay near the top of the Darwinex hall of fame for the past few years. That guy knows something.

Chapter 9 - Horse Racing and Market Cycles

That book by Bacon is such a favorite of VN's that he devotes a chapter to it.

There is no danger of the public ever finding any key to the secret of winning. The crazy gambling urge and speculative hysteria make that a certainty. But if the public play ever did get wise to the facts of life, the principle of ever-changing cycles would move the form away from the public immediately.

Robert Bacon

Secrets of Professional Turf Betting

- No one doubts that the public must lose at the racetrack in order to fund the prize money, stable care, employees and land upkeep. The 20% house take pays for expenses.
- The same models apply to markets and racing. Who pays for the CBOT and NYSE? Not the brokers, dealers, floor traders, jockeys or the insiders and large hedge funds. The public.
- Bookie's (a track bookie) rules for being a successful bookie
 - Integrity. The customer has to believe in my fairness or they won't come back.
 - Guts. You have to have courage to take on a big bet every now and then.
 - Initiative. You have to give the customer something exciting all the time or else he'll get bored.
 - Live a good balanced life without too many personal risks.
- Bookie becomes VN's mentor
- Laying off a bet - wagering on one side to win at odds, then betting on the other side at better odds, so he would be sure to make a profit regardless of which side won.
- A Dutch book - why take risk when you don't have to?

Elements of Handicapping

- A horse walking listlessly to the gate is like a market after a big move. Volume's dried up and trading is light. Buyers and sellers are saying they aren't happy with the recent price, the same way the horse is saying "I don't want to race."
- A favorite tactic was to bet on a horse ridden by a top-notch jockey that had performed miserably in a high visibility race. His thinking was that professional pride would lead to a particularly effective race next time out. (that and standard deviation)
- Also horses that were odds-on favorites to win a previous race but got beaten; bettors would avoid the horse because of bad memories, and this would improve the odds he would receive
- **Since then, 'betting the beaten horse' has become such a well-known tactic with the public that it's now one of the worst bets at the track**
- Steve Kagann - buys companies with a 50% decline and are the subject of unfavorable newspaper publicity

- Or stocks that declined but have insider buying
- O'Higgins -Beating the Dow
 - Buy highest dividend yield, worst predicted earnings change or lowest current P/E ratio
 - All such systems have above average results says VN
- **You can't have just one system for all occasions since the form is always changing**
- VN considers Bacon's 'Secrets' one of the best books he's ever read (and he's read a lot) and he urges us to read it. *Should I?*

Table 9-1. Racing and Market Win Factors

Racing Factor	Chance of Winning	Market Analogy
Highest win percentage	.19	Most frequent rises
Highest money earner	.20	Best performer
Fastest average speed in recent races	.21	Best recent relative performance
Best jockey in race	.17	Executive buying
Best trainer in race	.17	Owner buying
Highest win percentage on wet track	.15	Best performance in bear market
Closed strongly last race	.16	Buying at close
Beaten within one length of winner in last race	.16	Second best performance in industry
Favorite in last race	.20	Bullish consensus was highest
Won recent race in same class after drop-down	.16	Second earnings report after deficit
In trouble last race	.10	Declined after announcement
Dropping in company	.10	Delisted
Impressive qualifier	.11	Excited interest at road show

The Take

- A racetrack handicapper has to overcome a 20% house take just to break even; this is a good annual return for an investment fund
- Add to that admission cost, racing programs, newspapers
- Breakage - rounding down of the payoff to the nearest \$0.10 or \$0.20 (!!)
- The odds are then stacked against them so average racegoers are big losers
- **"Copper (bet against) the public's ideas...at all times."**
- If the majority of the public are losers the winners must be doing something different
- You will lose less if you bet less

The Consensus

- Most people get their info from a public and unreliable source

Discipline

- Most people don't have the 'iron ass' to bet only on the most likely 2-3 races
- Bookmakers earn a premium to quote two-sided markets
- The only advantage a price-taker has is in being selective
- To make them earn their money the speculator must watch many prices before placing the optimal trade
- You can beat a race, but you can't beat the races; when an advantage arises, press it; otherwise wait patiently

Emotion and Self-Doubt

- You won't notice the long-term winners because they remain inconspicuous; they don't show obvious emotion at winning or losing
- Removing all emotion is easier said than done
- The pro has no emotional attachment to his money
- Bankroll is just a means of keeping score
- VN enforces a ban on all jocularity and temper tantrums (!) in his operation
- Irving Redel, whenever anyone including family asked him how he was doing, he said "fair".

Beware of Switches

- Racetracks and financial markets are uncanny at shaking out the weaker hands
- "The average racegoer has no right to lose so much; it's almost as though they did it on purpose."
- The culprit? The Switch
- Pros bet on the winner, not the horse to place or show (2nd and 3rd); this helps them avoid the amateur's position switches
- The amateur bets to win but the horse comes third, then he bets for second and it comes third, etc¹⁷
- Then the amateur switches the size of their bets; they demand consistency from the horses but are utterly inconsistent themselves
- Switch-itis is lethal; stick to a constant number of contracts
- Stay with a systematic approach; a bad system is better than no system (and boy are there a lot of bad systems)
- Pros avoid switches by not playing too many races. They don't play the bad races at both ends of the daily programs. They don't play bad races. Period.
- It's not the losses that do you in, it's the switches (but also the losses)

The Principle of Ever-Changing Cycles

- The single most important principle about speculation says VN!

¹⁷ I don't know if I can find it but in my notes somewhere I thought I recorded a mathematical explanation for this phenomenon. By giving players more choices they actually spread out their small chance of winning over more spots, watering down their chance to earn a consistent return. It functions as a randomizer of something that's already nearly random. It isn't immediately apparent, even from a maths perspective because we're usually intent on considering just the individual odds of a trade/race. But once you split it into quadrants it makes sense (maybe). Got to find those notes.

- It has been applied to fishing, baseball, fencing, elections
- A vital, cardinal principle! (oh boy oh boy)
- This is too important to risk transcribing or interpreting so here it is directly

The collective “mind” of the public imagines that if it could only once find the “combination” for beating the races, it would be all set for life. The public wants to hit on some simple key, shown by numbers in the past performances, and use this key to get richer and richer as racing goes on. The public believes that if it could only once find that past performance key, its troubles would be over. . . .

Few players take into consideration the principle of ever-changing cycles of results, although the minor ups and downs of this principle can be seen at every long race meeting. The would-be professional player must always understand that the form moves away from the public’s knowledge.⁴

- In other words, it’s a pattern-erasing machine?
- New information files off the edge that is held by a select few; when that information is widely disseminated it loses effectiveness
- The example given is ‘Beyer speed figures’ for each horse which used to give a bettor a big advantage but now does barely better than a 38% loss. It has been overbet by the public so that now it has no meaning.
- The ever-changing cycle will continue to turn though, and bettors will become disgusted with their inability to realize a profit; they’ll switch to a new popular indicator
- This could make some old tricks new again
- The ever-changing-cycles work over short and long-term
- VN again uses a racetrack example;
 - some tracks (new ones?) had a clueless betting public;
 - The favourites were not bet down to unfavourable prices
 - So the horsemen just grabbed ready purses
 - The horses can keep winning as long as the public doesn’t get wise
 - But eventually they do. However they’re behind the cycle
 - The early winners are now tired and they’ve picked up weight penalties
 - Cash goes to horses that were running out of the money
 - The public goes looking for long shots and trick plays
 - The early form horses are now rested and lost some penalty weight so they have medium odds
 - If the favourites are bet down by smart money, second, third choices win
- Powerful says, VN. Keep this in mind when on a winning streak says Bacon
- Speculators in commodities notice that the trend-followers have had a great run and are sitting on cash.
 - When too much easy money is made, speculators look to make a fast buck by imitation

- Dealers who study points know that a trend change will occur if certain key points are triggered
- They start moving prices up to those points
- The chances of a successful trend follow is reduced; their fills will be less favourable
- The public is never in sync with these cycles; just when they're ready to follow a system it's the wrong time
- The gurus who called the 1987 crash gained big followings but then couldn't match the success of future recommendations because their following was tagging along; they can only play in liquid issues that tend to be fairly valued
- VN looks for the worst performing manager or fund to handle his money

Old Haunts

- After starting a family VN rarely goes to the track but decides to revisit it to see how things have changed in the 'cyberspace' era
- He compares it to Rip Van Winkle waking up in the space age.
 - Computerized access to info
 - Big screens/monitors
 - Live simulcasts, etc.
- What hasn't changed is the contrast between the pro and the public
- **The pro records and follows anything that affects the outcome**

Chapter 10 - Deception and Charts

A favorite device with him was to institute inquiries in the presence of the crowd around him as to roads and watercourses in a direction which he did not intend to take; even to order maps to be prepared, and roads laid down, as though for instant use. Having thus set every gossip talking and predicting his intentions, he would calmly march directly in the opposite direction.

"Mystery, mystery, is the secret of success!"

By a Virginia admirer from
The Life of Stonewall Jackson

- Deception is ubiquitous. Every lifeform is a master at it, from virii to homo sapiens
- **To ignore deception is a ticket to disaster**
- Sensible sounding advice like
 - Long-term charts are paramount to gaining the proper perspective
 - Look for repetitive cycles
 - Make a note of key highs and lows
 - Measure the time between highs and lows
 - Markets go through inactive and active periods; trending and nontrending

- Momentum shows trends
- Take a consensus approach with different indicators
- VN didn't make these up they are quotations from best-selling books on technical analysis

5 major lessons showing things are seldom what they seem

- The Natural Order
 - Artie (VN's father) would take him for walks through the wetlands (back when they existed) around Brighton Beach Baths
 - Nature is beautiful and you can learn a lot from it
 - Concealing, decoys, distraction, playing dead, Trojan Horses, key to winning in all sports
 - The various tactics of nature applied to sports, feinting, fading back, suddenly springing to life, faking handoffs, etc.
- Even Chess Players Cheat (*decades before Neimann!*)
 - Writing down a blunder on the scoresheet before playing a different move and changing it at the last second, to throw off opponents who might be reading the sheet
 - Poker face in poker and chess
- By Hook or by Crook
 - Hook serve in tennis
 - Borotra playing dead on the court
- Primates and Deception
 - The purpose of a big primate brain might be to deceive mates
 - Only lemurs use no trickery in the primate family; they have the smallest brains
- Deceptive Technical Patterns
 - VN has a conversation with Magee (of the famous Edwards & Magee) but it's not clear if it's real or not. He seems to be mocking the naivety of simple trendlines and moving averages
 - If monkeys and insects can deceive, it seems that speculators should pay more attention to it than does Magee (*and naive TA practitioners, among whom I count myself*)
 - Viruses invade bodies
 - Ants enslave other ants
 - Moths evade birds
 - General defeat generals
 - Girls and boys, con men, magicians, financiers, poker players, economists, mystery writers, painters using trompe l'oeil, actors, novelists adding twists to plots, etc, etc
 - **Weak hands get shaken out at just the wrong** (*or right, depending on your view*) **time**

Ecological Theories of Deception

- Energy used for deceptive behaviour crowds out other life-enhancing features; balance must be struck
 - Camo is better than running fast, because it works without expenditure; if a zebra escapes from a lion there could be a second lion around that he won't be able to escape; better not to be seen at all

Circumspection and Distrust; An Economic Theory of Deception

- Oliver E. Williamson's theory
- Businesses act the same as plants/animals in a jungle
- 'Transaction Cost Economics' - economizing on transaction costs is mainly responsible for the choice of one capitalist organization or another¹⁸
- Institutions achieve efficacy
 - Institutional environment - rules gives rise to
 - Governance - of contractual relationships within parameters dictated by beliefs and behaviour of
 - Individuals
- Madison, in the Federalist Papers
 - "As there is a degree of depravity in mankind which requires a certain degree of circumspection and distrust, so there are other qualities in human nature which justify a certain portion of esteem and confidence."
 - Williamson calls this depravity - 'opportunism'; the use of guile in pursuing self-interest
- Organizations develop sanctions for governance, that maximize profits while mitigating Machiavellian opportunism
- Buy or sell decisions according to Transaction Cost Economics
 - Price
 - Hazards (guile)
 - Safeguards - norms, customs, rights, laws, courts all make safeguards less expensive; in societies where these are lacking safeguards are expensive; this can include creating a hierarchical organization where internal matters can be settled internally; pre-emptive; can make new rules to control employees by fiat; endogenous preferences - propaganda to control thinking and respect the governance structure¹⁹

Principles of Deception

- VN studies war, sports and nature as a preliminary to studying deception in markets
- Predator and Prey
 - Much energy is lost in direct battles because both are so adept at their respective offensive and defensive tactics
 - Indirect approaches saves energy for both parties
 - Deceptive techniques emerge

¹⁸ Good news for Exolvr?

¹⁹ The Iron Bank!

- One side gains the upper hand and their tactic is passed on by genes, learning or sentences
- Then the other side counters this new tactic; the balance is restored
- This is the arms race
- BH Liddell Hart
 - After studying a long series of military campaigns he became aware of the superiority of the indirect approach
 - A direct assault of new ideas provokes stubborn resistance; intensifying difficulty in changing outlooks
 - The indirect approach is fundamental to politics, sex, commerce
 - Suggesting there is a bargain to be secured is more persuasive than urging someone to buy
 - The surest way to get a superior to accept a new idea is to convince him that it was his idea ²⁰



- The aim is to weaken resistance before overcoming it
- Draw the other party out of their defenses
- The Decoy
 - Example from the Old Testament
 - Sisera attacks Israel with 900 iron chariots
 - Warrior priestess Deborah advises Barak of Kedesh to raise a force of 10k Israelites and hide them on the slopes of Mount Tabor
 - A smaller force led by Deborah, lures Sisera's army along the river to a narrow marshy plain below Tabor where the chariots were bogged down
 - Then the 10,000 swooped down from the mountain and decimated the Canaanites (also the first ambush?)
- The False Gift

²⁰ Inception!

- The Trojan Horse story



- The horse was designed with beautiful carvings to look like a trophy to entice the Trojan's greed (Laocoon - beware of Greeks bearing gifts)
- The doors were concealed with cunning bolts
- Sinon - a double agent was left behind by the Greeks. He was paid to tell lies about why the horse was left behind and the consequences if it was refused
- The horse was intentionally built so large as to be impossible to bring inside the gates without removing part of the wall; the mainstay of their defence
- The Greek ships were hidden miles away in Tenedos
- When Laocoon hurls a spear at the horse to prove that it's hollow, the gods send a serpent to eat his sons and make it seem they were angry with him for his lies. (when the gods are not on your side, there isn't much you can do)
- The Holdup
 - A variation of playing dead
 - May 1940; British ship *Scientist* is bound for Liverpool carrying tons of chromium and maize.
 - The Kasii Maru²¹, a rusty freighter is flying the colours of Japan, neutral at the time, and approaching them
 - The Japanese sailors are lounging aimlessly ,a woman pushes a pram on the deck
 - Suddenly the swastika flag is raised and a shell is fired as a warning shot
 - The crew is hostaged and the ship is scuppered

²¹ Not in any way related to Star Trek

VN really pads out this chapter with detailed descriptions of mimicry, playing dead, but he rarely brings it back to the marketplace as he's having so much fun.

- The numbers in the major economic announcements are completely meaningless, subject as they are to revision, errors
- Sometimes the move can happen day before or day after the announcement - an ambush
- Stationary prices seem to be a favourite trait of bulls rather than bears
- Long-term basing (ranging) followed by a fantastic move is as common as flies
- Soft commodities are notorious for playing dead - the long growing cycle magnifies the influence of price quirks
- However then they can suddenly quadruple rapidly and wipe out the complacent; even the opossum will bite after playing dead

Table 10-1. Average Bond Price Change (%) Following Daily Moves of Different Magnitude

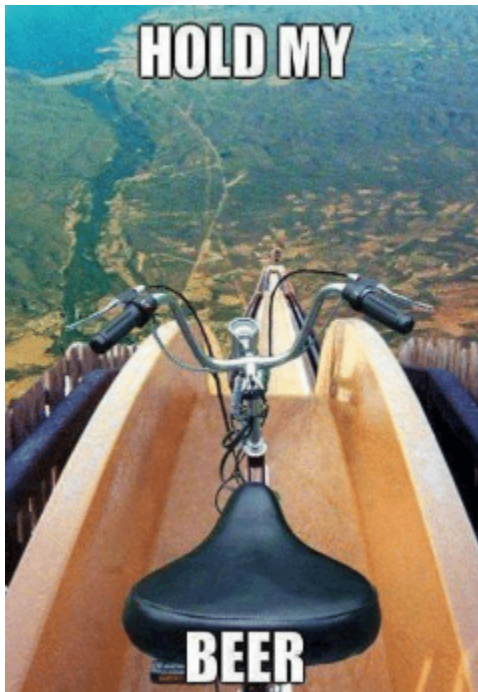
Subsequent Move	Daily Variation		
	Small Change	Medium Change	Large Change
1 day later	0.52	0.49	0.43
5 days later	1.29	1.16	1.05

- VN seems obsessed with ants; they can only detect each other by smell, and so many other species have developed the ability to mimic their scent and prey, enslave or parasitize colonies
- VN's Cloaking Conjecture (my name for it)
 - Moves will be inversely correlated with those that occurred following the one most similar day the previous year
 - April 17, 1995 - USDCHF - up from 87.6 to 89.08; a gain of 2.48
 - The most similar rise over the past year was March 31, 1995 when it rose 2.97 points from 85.91 to 88.88
 - April 3, 1995 (the next trading day) it rose further
 - So the April 18 prediction is for a decline
 - This doesn't work (why use it as an example then???)
 - However VN does an 8 year test that confirms the hypothesis (I guess I should test this myself. Any interest in hearing about the results?)
 - Correlation between the most similar move and actual move the next day is -0.10 which has only a 2% chance of occurring by chance (but what about time frames less than a year? And how is 'similarity' being defined?)
 - **The Swiss franc is a particularly deceptive market**
 - Of 100 different similarity relations tested, analyzing the most similar x days out of the last y days, only one showed a positive correlation with subsequent moves (the one he used as the example above??)

- “Considering the prevalence of trading techniques that use similarities as their base (nearest neighbour, neural networks, clustering), it is no wonder that dealers consistently make billions a year in trading profits by coppering their customers.”

Disruptive Behaviour

- The most spectacular form of deception
 - Quails feigning injury
 - Squid spraying ink
 - Skunks spraying skunk...musk?
 - Ants (again!) spray pheromones mimicking the slave targets ‘danger’ signal which puts the whole colony into a panic and allows them to carry off victims leisurely
- Dow
 - Small warning crash of 503 points on Oct. 19, 1987
 - Bigger crash on Oct. 20, 1987; futures halted
 - Scares bulls out
 - 250% rise over the next nine years



The 2000s, (although technically this slide should be going up)

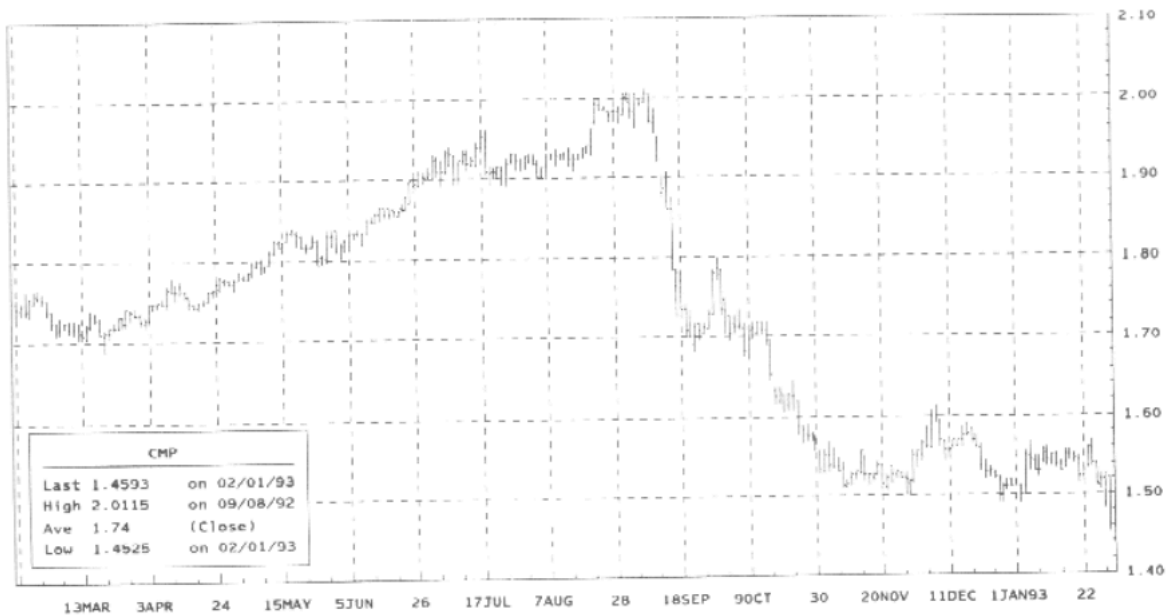
- Grain markets are worst for this



Tin: hold my beer?

Trapping

- Angler fish
- Trap door spider
- The most common deceit in markets. Too many examples to list.
- British pound September 1992;
 - After some ranging
 - Breaks the five year high
 - Trap is set
 - Shorts rush to cover
 - New buyers surge in
 - The pound plummets to 1.40 in four months; a 60 cent decline, \$40k/contract
 - Worse than being eaten alive, says VN



Source: Bloomberg Financial Markets Commodities News, New York.

Figure 10-3. British Pound

Tempo Fakery

- VN's fencing instructor has something to say about this incident
- This is an example of a Tempo Fake
- Start with a small jolt down; then close up unexpectedly at 1.965
- The December pound changed its tempo by delaying its actual move
- This causes speculators to misread the market or withdraw
- Curiously, the rest of the examples VN uses are all currencies
- Redoublement - a renewed attack in fencing
- A pause causes anticipation of a reversal but it just continues
- We are perhaps seeing a textbook example of that in CHFJPY



This was a textbook Sperandeo-123 with the breaking bar not retracing even a little bit. Many shorts piled in roughly at the arrow. Despite being a model of technical analysis perfection, it didn't hold, the trend resumed and bears are getting ground to bits. This trap is also enticing new shorts who will prolong the agony. Copper the public's bets.

Markets vs. Moths

- VN advises that these examples we've seen have no predictive power
- The market is rich enough to provide counterfactuals for all simple phenomena
- Arguments by evolution are often circular
 - Attribute X is beneficial for survival.
 - How do we know?
 - Because it exists.
 - Why does it exist?
 - Because the organism survived.
- What appears to be deception might be pure chance.
- Lowly moths can survive bird attacks. Imagine what Mr. Market can do.
- **Market life is hazardous.**

Chapter 11 - Sex

- When the Fed reverses course it's a great time to go with [it].
- The average run of contracting (raising rates) or expanding (lower rates) lasts about 3 years and involves seven consecutive tightenings or easings
- VN usually finds himself fighting the Fed more often than not
- He collaborates with Bloomberg's Caroline Baum on an article about Hillary Clinton's mysterious year of cattle trading.
<https://www.nationalreview.com/2016/06/hillary-clinton-cattle-futures-windfall/>
 - They make a fairly compelling case. Lock her up. But put Trump in the cell beside hers.

- This chapter has a (bodice-ripping) story featuring John Law (introduced by Sperandeo). I have no idea how I'd not heard of him before.²²

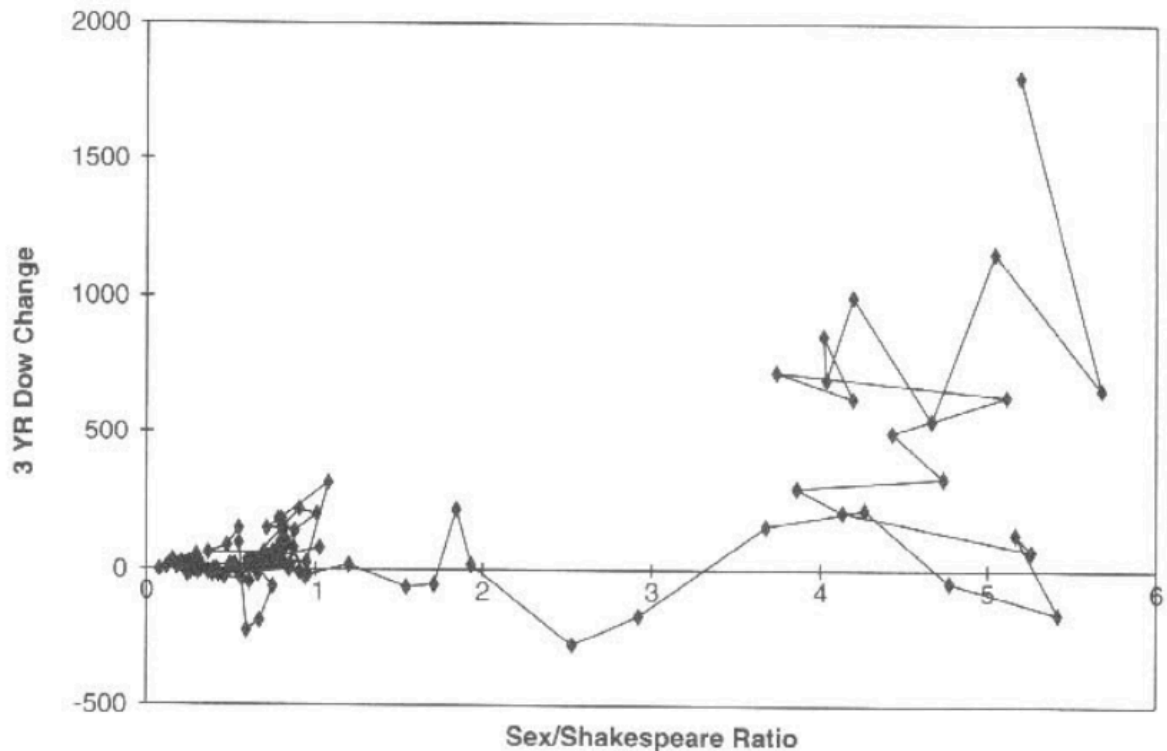


Figure 11-1. Sex/Shakespeare versus Three-Year Dow Change

LOL, as the kids used to say.

This chapter is truncated not because it's uninteresting or I'm being prudish but simply that it has hardly anything to do with markets.

Chapter 12 - Returns and Randomness: Academic Style

- VN says the only worthwhile things he learned at Harvard, were squash, and the ability to use the scientific method to “uncover and integrate regularities”
- James Lorie and Larry Fisher use a computer to show that stocks are a great investment in the 1950s (we take it for granted, but it's nice to have proof)
- Engel and Hecht: How to Buy Stocks
 - **If you invest on a time horizon of ten years using a portfolio of stocks it's actually hard to lose money**

²² This would make a first-rate historical fiction novel; probably there are hundreds.

- There were only 72 negative rates of return out of 2,211 year-to-year combinations between 1925-1991
- If you extend your horizon to seven years, only five losing ones
- Bob Gwinn
 - VN gets a \$25k stake from him to short a printing equipment manufacturer
 - He invests more money in the short as the stock price rises
 - Gwinn invests his own money
 - Together they lose nearly \$100,000 as the bears get squeezed
 - A month later the company goes bankrupt
- Wilton Jaffee
 - Bumps into him while moping on Broadway
 - Tells him about the short squeeze
 - “Oh yeah, we had some fun squeezing the shorts on that one. Really took some of those midwestern hayseeds to the cleaners.”
- If anyone offers you a bet on a sure thing, take your wallet and run in the opposite direction
- VN now never will short without a hedge; this saves him when he tries to short silver and his long gold hedge saves him
- The 10% annual return in stocks is the best reason not to go short

Random Walk Theory

- Teaches that all info is in prices
- A firm's capital structure or dividend has no effect on its value
- Price movements generated by random processes look just like real charts
- Analysts and funds have random performance
- Market-timing is inferior to holding
- This was the academic line for decades
- VN notes that among six or so students in his classes who espoused that theory all of them have gone on to careers with firms whose 'raison d'etre' was to find anomalies in prices
- VN paints a dramatic picture of himself defending his ideas against the intractable resistance of the old guard at the Ph.D. Finance Seminar.
 - His argument is basically that there is no methodology to prove that prices are random because you can't prove a negative
 - He isn't allowed to continue because they didn't want to hear about things they'd already read
 - His statistics are challenged based on the grounds that stocks have infinite variances, his samples were small, unrepresentative, and even if they were correct they couldn't overcome transaction costs so no value to anyone but specialists and floor traders
- 30 years later VN still refutes the theory but has updated
 - The strong version of the theory is supported by myopic academic research full of biases
 - He finds that earnings are the key to individual stock performance

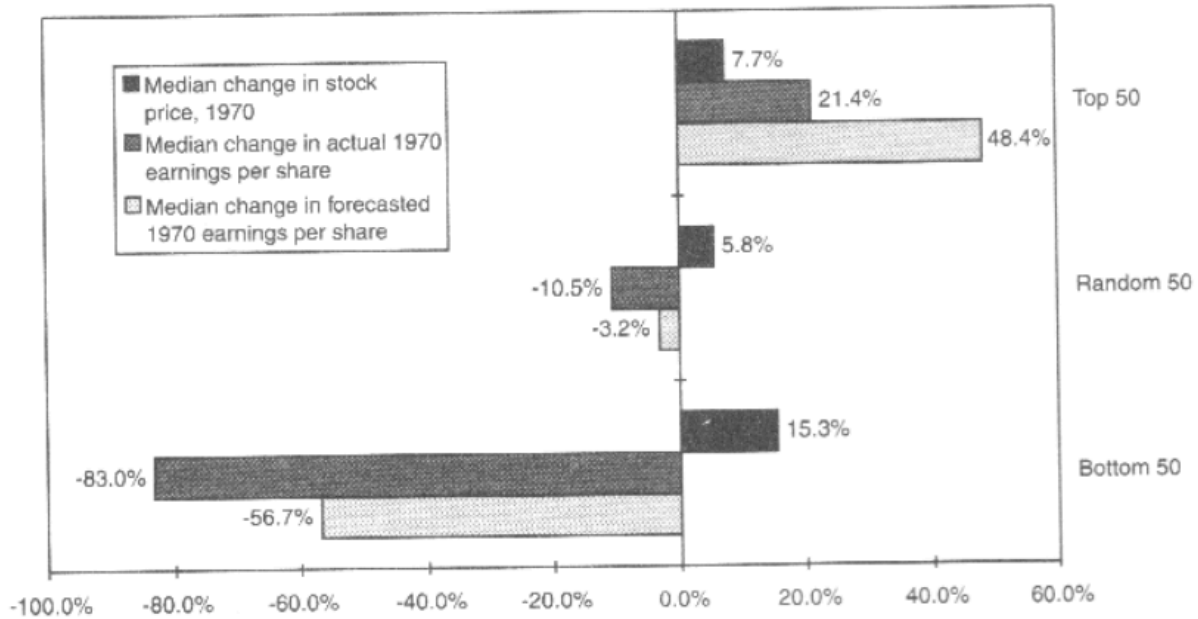


Figure 12-1. Median Changes in Forecasted Earnings, Actual Earnings, and Stock Price, One-Year Horizon

- However earnings forecasts are inaccurate; price performance of terrible forecasted earnings is superior to that of companies with excellent forecasted earnings²³

Transactions and Regularities

- Limit orders to buy tend to cluster below the market
- Limit orders to sell tend to cluster above the market
- Market orders to buy must be sufficient to overcome the limit sell orders before consecutive rises can occur (and vice versa)
- A dull market where prices range can go up and down hundreds of times before a continuation takes over
- This produces four nonrandom properties
 - There is a general tendency for price reversal between trades
 - Reversals are relatively more concentrated as integers where stable slow-moving participants place their limit orders (*smart money?*)
 - Floor traders knowing the locations of these limit orders, take positions at nearby prices, pocketing the spread (*safe arb*)
 - After two price changes in the same direction, the probability of a third change in the same direction as the second is > two changes in opposite directions ([proven to my satisfaction earlier in the book club](#))
 - These tendencies are now well documented says VN
 - Odds ratios of reversals vs. continuations is 5:1 says VN (*something I couldn't prove*²⁴)

²³ An excellent example of 'man-in-the-window' theory?

²⁴ Although Schooner seems to bear it out?

- Days of the week
 - Monday might be better for some reason I don't get
 - The action on a Monday might be particularly bearish after a Friday that was sub-par; VN Says this basic idea has made his customers 9 figures (the Blue Monday effect)
 - Chances of a rise in the last four days of the week run 13 points higher than on a Monday
 - However these discrepancies are not enough to rise above the transaction costs
- Results that appear significant in one period can evaporate in another
 - If something is there to be found it will be found and exploited and killed
- Academics don't consider that shrewd operators might know something and keep it secret
- Members of 'the trade' hire smart graduates to keep abreast of new developments
- Even if it's a delusion they can front-run those who believe in it.
- VN checks the daily discrepancies years later and finds that they have reversed from when he tested it²⁵
 - However that doesn't stop academic publications from publishing the exact opposite findings
 - This is good news for contrarians

²⁵ Ever-changing cycles

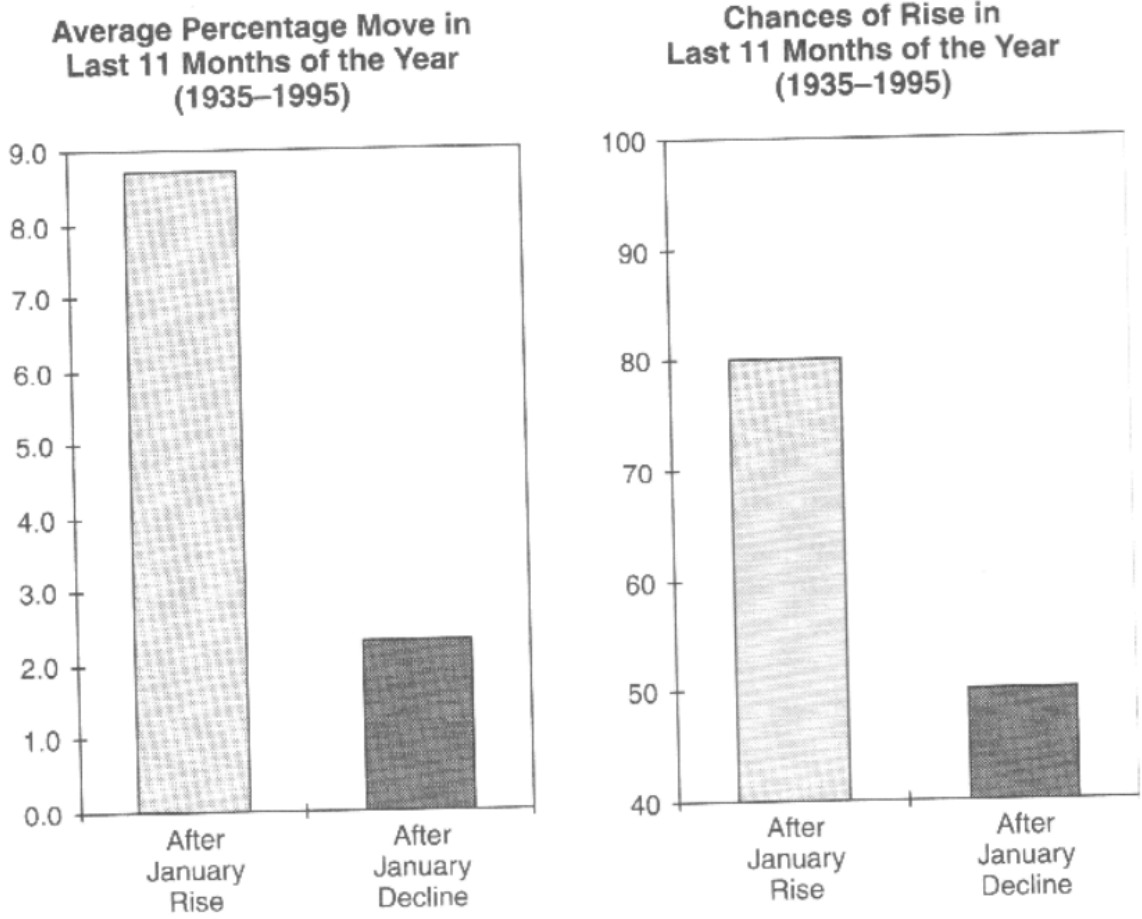


Figure 12-2. The January Barometer

- I would just say be suspicious of statistically significant effects for which the cause is not known or cannot be surmised

	Mean		Mean
January	1.2%	July	0.8%
February	0.0	August	1.5
March	0.6	September	-1.0
April	0.9	October	0.0
May	-0.2	November	0.5
June	0.3	December	1.1

•
An Ounce of Testing

- Turn of the Month Effect
 - Robert Ariel divided the months into two halves
 - He computes returns in both halves but adds an academic twist - using equal-weighted and value-weighted indexes
 - He finds returns are greater in the first half of the month
- VN says buying a stock based on the first letters of its name is all you need to know in many cases
 - Biotech bubbles, any stock with the word bio in its name will rise
 - When the value of such stocks is measured in price/patents its near time to get out
 - Same with companies that have 'tech' in their name
 - 'Onics'
 - 'Computers'
- If a country's rate of return is due to high interest rates its neighbours are likely ready to feel the same effect
- The story of the rabbi whose wine cellar burned down
 - The townspeople plan to restore it but the cost is too high
 - So they agree to each bring a bottle of wine to his house and pour it into a vat
 - When the rabbi turns the tap out comes pure water
 - They had all said to themselves. What does my contribution matter? It will all end up the same.

Chapter 13 - Connections to Monitor

- Darwin
 - Cats eat mice
 - Mice devour bee nesting sites
 - Bees pollinate clover
 - Cattle eat clover
 - The presence of cats in one area could determine the numbers of cattle in that same area by a series of hops
- The Domino Effect / Butterfly Theory
- El Nino and anchovies
 - El Nino is a weather pattern
 - Anchovies need cold water
 - El Nino reduces cold water
 - Reduced anchovies means poultry and cattle feed needs to be supplemented with soybeans
 - Soybean price goes up
- In the 1960s there was a strong correlation between Hong Kong stocks and the US stock exchanges; by 1995 the relation vanished
- Hot sector was now tech

- High tech stocks creator near the end of 1995 as Fidelity/Magellan shed its holdings “shortly after touting their eternal value”
- Hong Kong then rallied 15 percent in 2 months in 1996 as money shifted
- Emerging markets now dance to the Hong Kong tune
- March 11, 1996 - HK has the third largest decline ever, falling 7.5%; not due to fears of war in the Taiwan Strait but fears that Greenspan will tighten
- Feedback loops can be mindboggling
- Emerging market portfolios base exposure on US monetary policy
 - When the Fed tightens they ‘rush like lemmings’ to Hong Kong, Singapore, Mexico because they export a lot of GNP to USA
 - When the Fed eases they jump to India, Korea, South Africa, because the connections to USA are more distant
- Jesse Livermore preferred to speculate out of London to be closer to the action
 - 1907 during the panic he hopped the first trans-Atlantic steamer to inspect the carnage
 - Every speculator ‘worth his salt’ must track the moves of the US stocks in Tokyo and London, the Asian markets, European markets after NY, all to get a handle on what’s in store for the USA
- Futures on foreign stock markets traded in Chicago simply copy the Dow and USD during the NY session. “Emerging Markets Quiet Awaiting US Data” is the perennial headline.

Reasons for Interrelations

- Many varied reasons
 - Shared language
 - Physical laws of conservation, especially of energy
 - Common genetic heritage
 - Societal ties
 - Substitutable goods

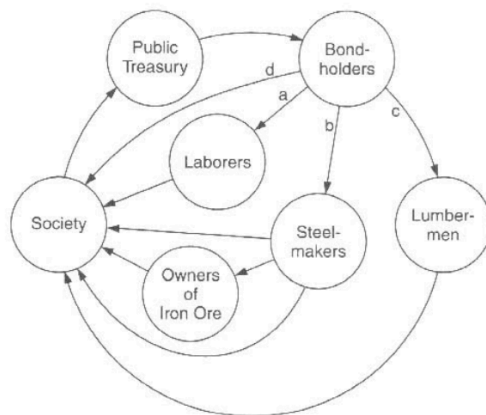


Figure 13-1. The Circular Flow

○

Bogus Interrelations

- Sunspots
- Generalizations about long-term moves (overlapping graphs) (and yet this so common that even VN has done it in this book)
- Most charts aren't adjusted for cost of carry
 - Production numbers increase with GNP
 - Price series move up with inflation
 - A five year chart has only 10 semiannual data points; there won't likely be more than 3 turning points; so naturally it looks like one series moves up/down or before/after or with the other
 - Stigler's chart on German birthrates correlating with declines in stork populations (the irony here is they could well be linked, but inversely correlated; decreasing birthrates == greater standards of living == greater natural resource extraction == greater loss of habitat == reduced stork biodiversity)

Humility in Interrelations

- Change one thing in nature and everything else is affected
- Fragmented, shifty, random is the nature of market interrelations (ever-changing cycles, you already said it, Vic!)
- VN goes into the reasons behind the 1987 crash, differential between dividend yields and fixed-income yields, foreign investors reluctant to hold US debt, James Baker going on TV to say the Germans need to buy more US goods or they'll allow the dollar to decline; Pohl blames Baker for the crash (the problem is a reason will always be found after the fact even when no one would be able to connect the dots beforehand)
- The following day the feedback process was at work to contain the calamity
- Yield differential between stocks and bonds moved almost the entire distance back to year-end 1986 levels in 1 day; dollar recovered 2% 'signalling that Baker would not do it again' (how can you know?)
- Copper and silver declined 12% the next day, signalling US industrial activity would be subdued for the future
- Stocks recovered 114 Dow points, about 1/3 on the way to a 100% gain over 8 years
- VN ignores his customer and his wife's advice to avoid stocks on the Monday of the crash and he gets wiped out; in fact he was 'goaded' by their advice. (never give or take advice/tips!)

Recency Effect

- You remember the last place you parked your car but you tend to forget the other places
- This survival trait is useful in finding a book, thought, ring, but it's a killer in the markets
- The memory of big stock market crashes lives on in the collective consciousness
 - On the crash day the Fed intervened to buy treasuries
 - Fixed-income prices gained 10+ percentage points in one day
 - Since then, stocks have pretended to crash at least 50 times
 - Speculators rush in to buy bonds and sell stocks on every fakeout

- More money has been lost by bears in such manoeuvres than in the Oct. 19 crash

Intermarket Correlations

- VN waxes philosophical about global economies and their complexities but I'll just summarize by saying - economics is hard
- Economists can't even agree on the determinants of exchange rates; there are 3 theories.
 - Balance of payments approach - focus on short-term and long-term flows of money in/out of countries
 - Portfolio-asset-management approach - focuses on expectations about returns and risks of holding currencies within an efficient portfolio of other assets
 - Technical analysis approach - favoured by 90% of practitioners (*practitioners of what? TA? Then he's saying 10% of technical analysts do it but don't believe in it??*) MAs, filters, EWT, Fibs, mumbo jumbo that this book has hopefully cautioned against

Japanese Case Study

- VN describes his experience trading the yen in '94 and '95.
- 1994
 - US bonds, small stock, dollar:mark and dollar:yen markets dropped by 10+% wiping out trillions in US wealth
 - Popular explanation was foreigners decreased holdings of US assets because: fear of USD declines
 - The more USD declined the more it seemed the decline would continue, leading to further selling of USD assets like stocks and bonds
 - There was history behind this fear
 - 1986, April
 - It would cost a JPN investor 185,000 Yen to buy \$100k of the 8% US bond in futures
 - End of April 1995, the falling dollar reduced the value of the 8% bond to 84k yen; 55% decline on principal
 - However end of year 1995 the bond had advanced 50% to 125k yen
 - JP Morgan research group developed benchmarks for predicting the value of the USDJPY. VN knows no quantitative studies done to test the validity of these methods. But he calls them 'the laureates'
- The yen rises in 1994
- US fixed income cratered in 1994
- VN makes 'good money' by considering feedback relations
 - 'They' will be on alert to halt USD declines
 - 'They' will prop up the dollar around Tokyo lunchtime for the NY opening
 - VN buys the dollar
 - 9/10 times he does this the central bank leaked news of intervention

- VN figures either the central banks were following him, brokers confused his action for theirs, or it was just dumb luck, but interventionists were making their moves at the same he did
- This made him the most successful fund manager of 1994
- Correlation between USD changes and US stocks was positive in 1994; about 30% daily cent. On 18 days, for example, the dollar declined by more than $\frac{1}{2}$ percent against both the deutschemark and the yen. The average decline in stocks on those days was 6 Dow points; the average decline in bonds was $\frac{1}{2}$ point. For the 17 days when the dollar rose in price by more than $\frac{1}{2}$ percent against the yen and the deutschemark, the average rise in stocks and bonds was, respectively, 12 Dow points and $\frac{1}{3}$ percent in bonds. Because the bonds declined about 13 percentage points during this period, the rise in bonds was particularly nonrandom. Exemplifying a cruel penumbra that prevents those with short-term horizons from achieving great wealth, the subsequent moves completely reversed this effect.
- Easy ways of making money disappear in time
- 1995
 - US stock and bond market rose continuously as the USD drops
 - March 5 - 7, 1995 USD drops from 93.50 to 88 yen in 36 hours after having declined four big figures in the previous five days
 - VN figures the carnage must be over
 - Newspaper headlines foretold imminent disaster if the decline is not halted
 - USD status and future viability of Japan are questioned
 - Rumour of MITI and MOF - Japanese industrial and financial planning authorities
 - Urging JPN institutions to sell their \$50B of US bond holdings for deutschemarks
 - VN figures 'they' will step in again
 - But when he buys USDJPY this time he stands in front of an avalanche alone; the yen moved down 2.5% in an hour
 - At 10x leverage he loses 25% of his assets in 1 hour
 - At 4PM March 7, the Japanese, through counterparts in central banks in NZ, AU, and HK started buying the dollar; reversing the entire move before dollar bears knew what hit them
 - VN rushes in to buy JPN stocks
 - A trade deal is reached
 - But instead of rising the JPN stock market drops 5% as often happens when good news is confirmed; dollar rose 2% against the yen on euphoria
 - VN can't take another 25% drubbing so he dumps his holdings
 - On cue, the JPN stock market marches up 40% from his bailout point
 - **Selling out when fear is greatest is the worst time to sell**

Japanese Field Trip

- VN goes to find out the cost of a big mac ([the big mac index](#))
- He sees 299/300 office workers wearing white buttoned-down shirts; the nail that sticks out gets hammered; he concludes the Japanese market participants are followers rather than leaders
- The story of Hachiko, the dog whose story is possibly the inspiration for [Seymour in Futurama](#)
- When VN suggests that sake-fuelled Kobe beef revels allow dissemination of economic numbers like the US trade balance hours or days before traders in the US can profit from it, a former Fed governor angrily retorts, “we’re not a sieve like the Japanese!”
- The Fed governor senses that VN is insincere and doesn’t hold him in reverence like those in the command sector have come to expect, and he hangs up.
- He still finds that the moves in JPN markets on the day before important numbers are announced in the US are invariably on the mark
- He especially likes the 0:00GMT - 06:00 GMT move in the USDJPY because this ‘sings like a canary’
- After visiting Japan VN vows never to buy into news about a crisis of this 2700 year old dynasty

CONNECTIONS TO MONITOR

315

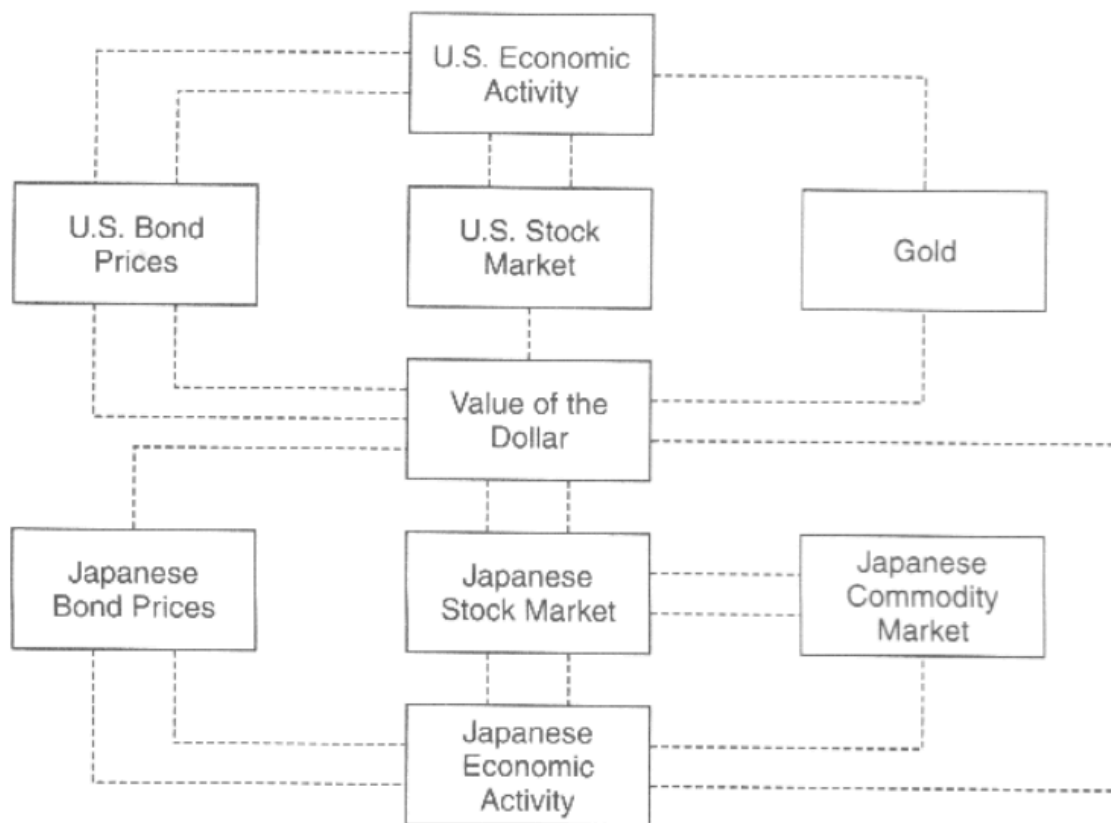


Figure 13-3. The U.S.–Japanese Web

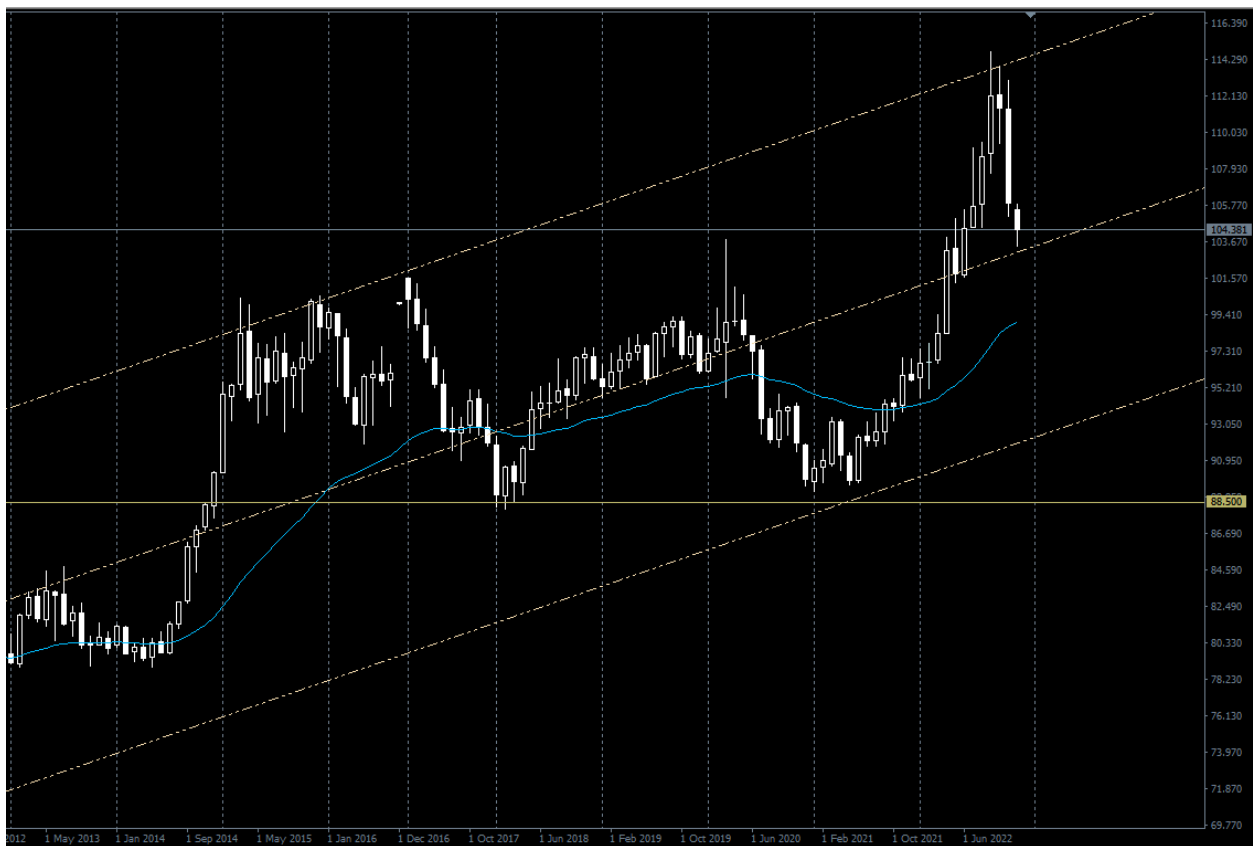
- As JPN economic activity rises, demand for USD increases to finance imports of US goods
- Value of USD goes up; value of JPY goes down
- As dollar rises, JPN exporters become more competitive; JPN stocks go up

International Correlations

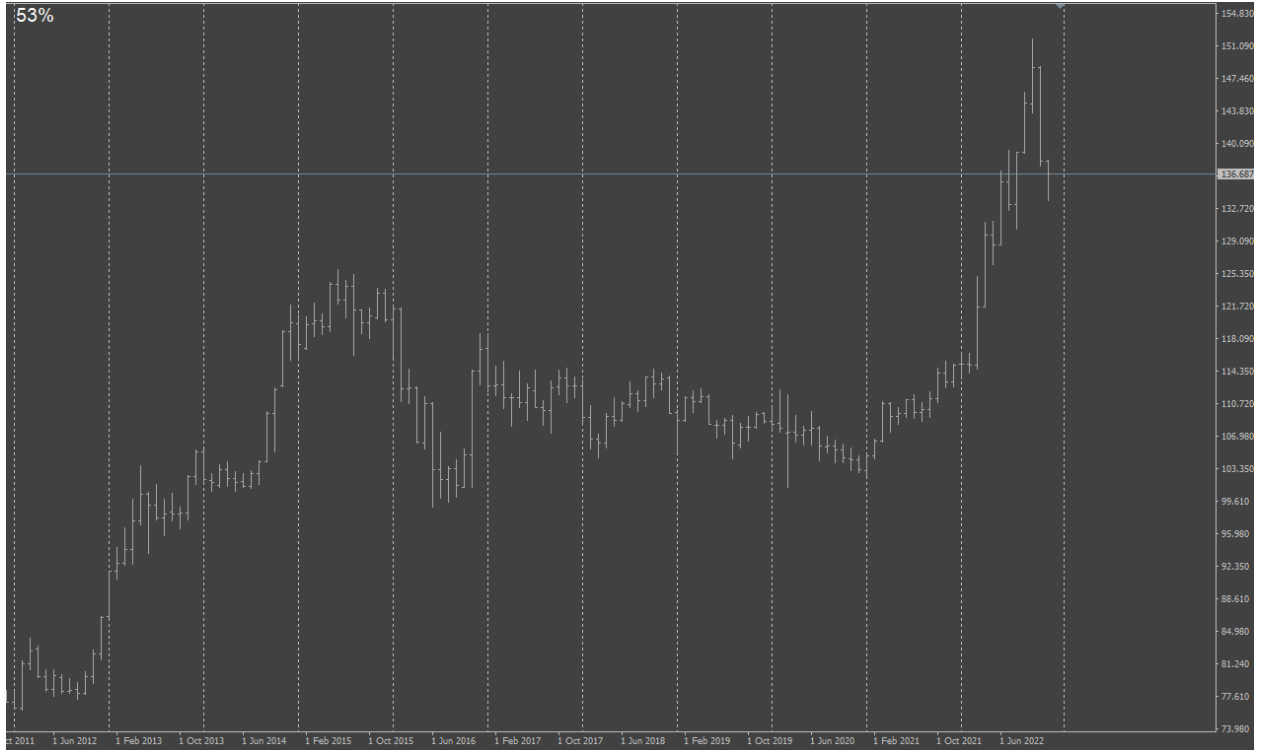
- 78 separate daily correlations between domestic equity, interest rate, and currency markets
- US and Euro fixed-income markets are highly correlated
- Euro equity and fixed-income markets move closely but opposite to their currencies
- Highest correlations are between Euro fixed-income markets
- US stock market is correlated about 0.5 with English and French markets; only 0.13 with the Nikkei
- All currencies are negatively correlated with their respective stock and bond markets.

This is very easy to check at a glance, at least for stocks. Let's consider the USD and the SPX500 vs the EUR and DAX30 over the past 10 years.

I'll use the US dollar index to gauge the value of the USD. I could use USDJPY just as readily.



USDIDX



USDJPY

You see they are very closely correlated. As you'd expect.
 Now let's examine SPX500



SPX500

Fairly homogeneous.

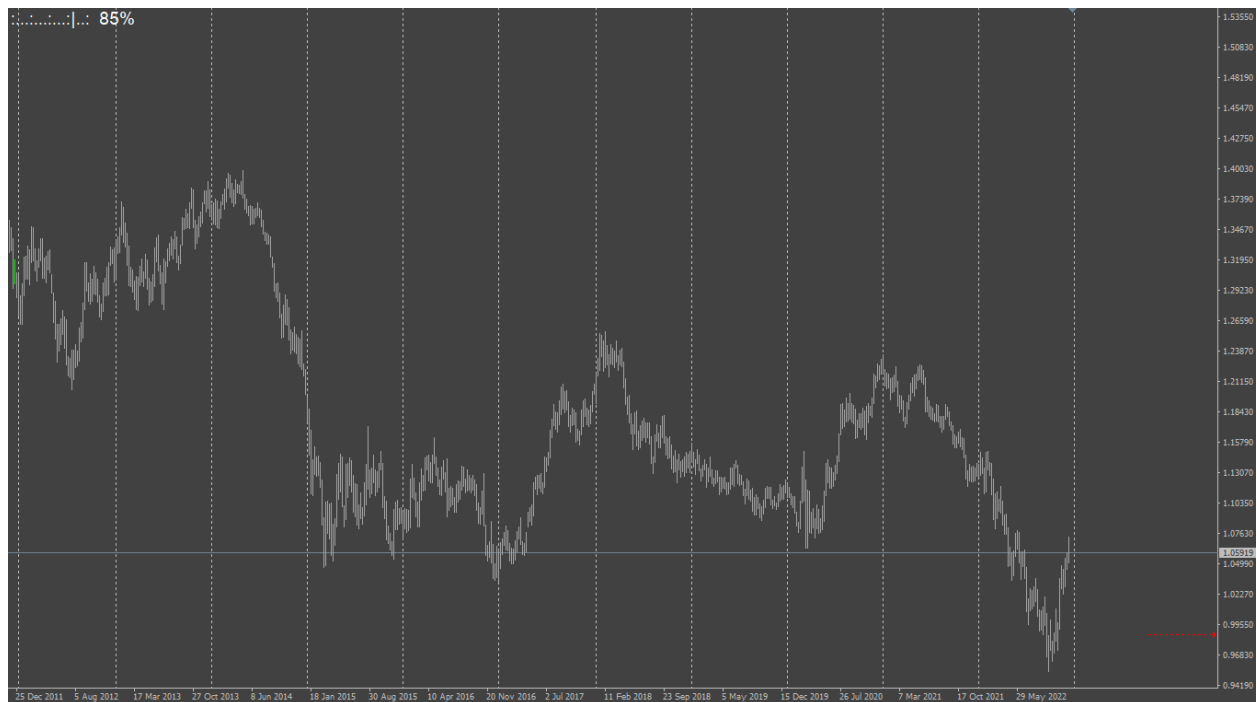
Just eyeballing this we can see the charts are broadly similar. They both go up and have dipped down in some common spots.

Now let's make a table comparing their correlations using a simple up/down/flat matrix.

year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
USD	FLAT	FLAT	UP	FLAT	FLAT	DN	UP	FLAT	DN	UP	UP
SPX	UP	UP	UP	FLAT	UP	UP	DN	UP	UP	UP	DN

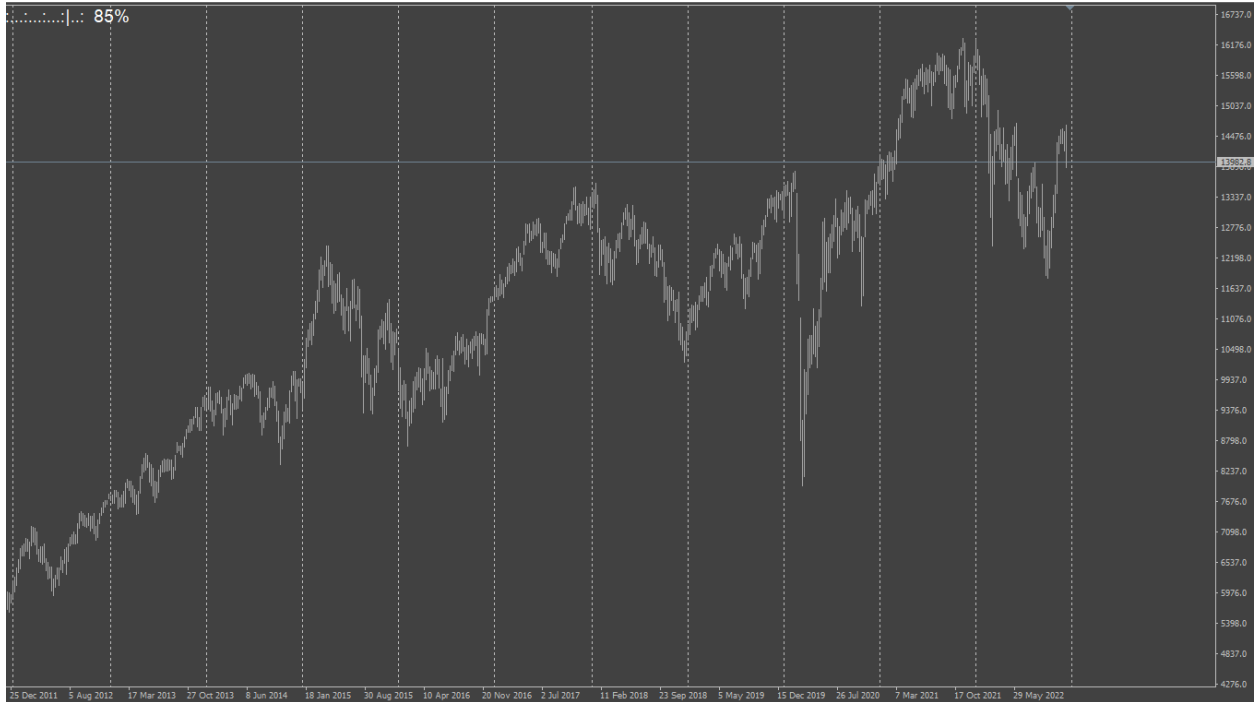
At least on an annual basis the results are not convincing; some years they are correlated and some they are inversely correlated, while others are inconclusive.

What about the Euro?



EURUSD

Unfortunately I don't have something like a Euro index, but the EURUSD is basically, by definition, the anti-dollar and the standard expression of Euro strength or weakness. More so than EURJPY, but please correct me if you feel I'm reaching.



German DAX

A much more interesting chart than the SPX. Why am I using DAX rather than EuroStoxx or CAC? Well, I could, but the economic news that most affects the EUR is usually the German news, as it remains the economic powerhouse of Europe.

Again we use a simple matrix using a simple determination split up by year.

year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
EUR	FLAT	FLAT	DN	FLAT	FLAT	UP	DN	DN	UP	DN	DN
DAX	UP	UP	FLAT	FLAT	UP	UP	DN	UP	FLAT	UP	DN

Again, the results are not at all convincing, though perhaps a bit closer than the first comparison. What I do see is that EUR to USD are inversely correlated as you'd expect, and SPX and DAX are fairly closely correlated, as you might expect from two equity indices.

year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
SPX	UP	UP	UP	FLAT	UP	UP	DN	UP	UP	UP	DN
DAX	UP	UP	FLAT	FLAT	UP	UP	DN	UP	FLAT	UP	DN

Now that's correlation. What else can we say about all this?

Breaking things up by year, forces a 'trading horizon' on the forecast so that we don't have forever to wait for things to line up just as we expect; just as you'd be dealing with if you were actually trading. Over an infinite time span, eventually EVERYTHING will correlate.²⁶ This makes paying too much attention to correlations, if not pointless, at least something that should be confined to a particular horizon. Clearly this well-known 'correlation' isn't very useful for trading MN or even W1, at least in the modern era. Maybe it's more useful intraday? I doubt it though.

Since VN goes on and on about other types of correlations, but I have shown that even the most obvious correlation possibly isn't, I'm going to skip the rest. This is something you'd have to investigate on your own if you believe correlations are a useful trading tool.

- If a regularity became too glaring it would immediately be washed away by all the hawks.
- What matters isn't the impact of moves in local markets, it's what participants in one market expect to happen based on those impacts.
- No wonder it's hard to make a profit, due to the complexity
- VN believes he is the first to have analyzed these interconnections systematically

This joy of discovery is tarnished by five sobering factors

- Interrelations are always changing (because they are cyclical, and possibly aperiodic?)
- His students have started their own businesses exploiting the same ideas
- Books and articles about intermarket analysis and their ideas are now commonplace
 - VN points out that the level of analysis hasn't advanced much; like astrology or alchemy vs. modern medicine
- Computerized black boxes tracking all major market interrelations (and now, everything)
 - One group selling a product similar to the one VN developed for his own use said they had sold 400 to a bank for their traders
- Top traders have clubs where they can discuss the day's interrelations (and how they're going to collude to fix prices)

Chapter 14 - Music and Counting

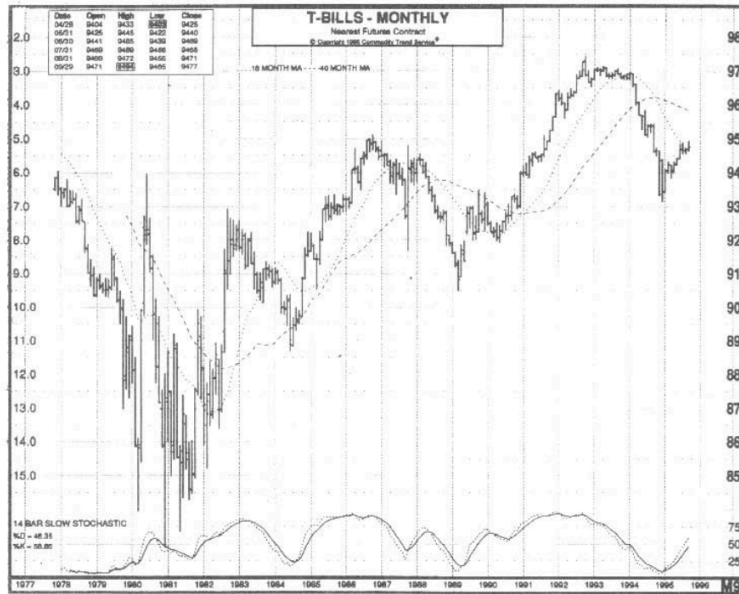
- VN compares the markets to music²⁷

²⁶ It's a bit like Solon's advisory, "count no chart bullish (or bearish) before you are forced to exit the position."

My personal opinion, which belongs in the footnotes where no one will see it, is that these things are entirely cyclical, often aperiodic, and so when things line up they look like magic, but when they stop lining up, it will be right when you decide to enter the trade. Useless. This is another reason that VN might have gone broke. He was putting too much faith in spurious correlations, treacherous things that they are.

²⁷ While the comparison may seem absurd at first, consider the evidence for 'octaves' and how many finance authors have compared the game to musical chairs, or the chart to a song made

- A frequent work he hears in the market is this one. <https://youtu.be/VOLy6JxEDLw> Don't turn it up too loud or you'll blow something.
- <https://www.youtube.com/watch?v=NtzEdLS6IQA> Artie's favorite tune (the playful trout!)
- <https://www.youtube.com/watch?v=0fOiCgdwLaw> The LoBagola pattern (back and forth) is compared to Treasury futures from 1976 to 1992



Source: Reproduced with the permission of Dearborn Commodity Trend, Inc. All rights reserved.

Figure 14-6. Treasury Bills, 1977-1996

up of lines. Music is merely waves of various frequencies and a time series of prices is also made up of frequencies.

- <https://www.youtube.com/watch?v=5OHBP3iS4D0> which VN describes as 'scary' and compares to this chart



Figure 14-8. NST Yapi Kredit Bank, May 1991–May 1996
329

- Memories of violent soybean futures movements, up and down between \$5 and \$10 every couple years.
- The music of market crashes is Beethoven's first movement of the 9th symphony. The music of the end of the world. <https://www.youtube.com/watch?v=ke6SatPLzaw> (awesome! I wonder why this doesn't get used in movies?)
- Swiss drug companies hire math champions to trade options which they consider as important as finding new drugs
- A simple algorithm for translating chart notation into musical notation
 - Take the total range of the previous day (or 50 points around yesterday's close)
 - Divide it into eight intervals or notes, starting with middle C as the previous close
 - Take each half-hourly price, round it, and assign it a note
- What you get is often something like a nursery rhyme (three blind mice)
- Eastern markets show more 'continuity' than Western ones
- VN argues that much of Western music and fiction follows an A-B-A form, with the A being the melody, the B, providing contrast; this A-B-A form dominates the market, he says

- B-A-B happens often enough to stop anyone from making too much money by betting consistently on the A-B-A form.²⁸
- VN hires a floor trader who believes there is a 1:1 correspondence between score notes and stock market moves for the year. VN gives him 'six figures' in initial capital and he loses 100% in 3 days, leaving town 'as poor as Berlioz'.

For Music Mastery	For Speculation Mastery
1. Allow no day to pass without practicing with your instrument.	Study the market every day.
2. Get to know how your equipment is made and how it performs under all weather conditions.	Visit the exchanges. Be wary of rain and wind, and learn how to program in an assembly language.
3. Start each day of practice by playing a single tone with varying degrees of touch and dynamic quality.	Start with the stock market first.
4. Play one hand at a time where required by technical difficulty.	One position is enough.
5. Never fool around, even when no one is listening. Perfect practice makes perfect performance.	Don't boast or tell friends how great your system is or throw a few contracts in "just for fun."

²⁸ I've done a W / V test on many forex pairs that shows that this is basically true; You often get a W or inverted W pattern in the Euro, but when you try to use it as a basis for a system, it fails consistently

6. Whenever you make a mistake, go back and repeat the passage correctly when no one is around. Keep a record of all your losing trades. Were you in over your head?
7. Master all the technical aspects of your play and get in condition months before your performance. Then, when you perform or compete, you'll be able to concentrate on the intellectual and refined aspects. Shading and dynamics create great performances. Paper trade before you start. Save up adequate capital. When you trade, vary the size of the position based on your assessment of the distribution of return and risk.
8. Play from memory. You can't soar when you're looking at a transcript. But take notes and keep a diary of all the pluses and minuses after you play. Calculators or computers should not be consulted during the trading day.
9. Get into the performance hall an hour in advance, and acclimate yourself to the environment. Don't talk to anyone or shake any hands before or during your performance. Get to work by 7:10 A.M., not 8:10 A.M., just ten minutes before the markets open.
10. Study the most elemental pieces and decisions from the standpoint of an expert. You will be astonished at how difficult it is to play a Czerny, or even a Clementi Sonata perfectly. How would Soros have traded that one lot?

11. Don't become stale trying to overcome the difficulties of a piece. Come back after a breather, and approach it from the beginning as if you didn't know it.	Take a break when you're losing.
12. Cultivate and nurture all emotions during practice. Open the floodgates during performance. But restrain ostentatious, visible emotions when performing.	No high fives, crying, alibiing, or bemoaning missed trades during the trading day.
13. Surround yourself with great masters of your art. Attend their performances. Study their books. And pay up for their lessons.	At least four books by Soros, and three about him are available.
14. Don't have sex just before, or during, your play. It will crowd out the climax your performance should create.	Stay away from badinage with those former models who cover you.
15. Don't replay the notes or fingering you missed during a performance. Once you look back, you'll be off on all the coming music.	Forget about the great prices you could have traded at. Should you enter, add, or exit <i>right now</i> ?

- If you're a Bach, don't worry about the rules
- Mysticism, describes everything, predicts nothing ([much like this chapter](#))
- Counters know their opponent's likely holdings and the remaining cards at all times. Quite an advantage.
- After a big rout on a previous day VN has seen markets open like Beethoven's fifth (ta-ta-ta-tum); three quick notes, and a long unmeasured lower
 - Hope springs eternal so the next day is likely to begin with a few short small spastic trades slightly above the close, then the big boys lower the hammer of reality

I called Artie the next day for some Monday morning quarterbacking. “Wasn’t that amazing? Did I exaggerate when I said it was the most exciting music you’ll ever hear?”

He was reticent. Finally, he replied, “These powerful forces, they’re like an avalanche. How can you withstand them? Remember the bodies of the big-shot speculators I had to deliver to the morgue? You’re in over your head.”

“Don’t worry, Dad,” I replied, “There’s no danger. I have it all quantified.”

Chapter 15 - the Ecology of Markets

- VN spends several pages comparing the markets to a natural ecosystem, **which they surely are.**
- Losses take the form of food and energy
- The primary consumers of these are the FX and fixed-income dealers - banks and investment brokers; Bankers Trust, Goldman, Citi, Morgan Stanley, Salomon, UBS
- Secondary consumers who feed on the banks are large hedge funds, Quantum, Tiger, Omega
- At each step orders and volatility are broken down into chunks and recycled among the decomposers such as floor traders, and telephone brokers
- The public is made of futures traders, stock flippers, market timers, system clubs, tape watchers
- Their mortality is high; they are always in flux
- Characterized by inflexibility, ignorance, arrogance, myopia, hesitancy, undercapitalization, overconfidence, spendthrift, hopefulness
- VN admits he sometimes plays the part of the public, taking bad gambles
- **The role of the public is to be eaten**
- Stanley Kroll - futures broker in the 1980s; was successful but got discouraged because none of his clients made any money; no other brokers at his brokerage house had any winning clients either
- Public futures traders are therefore rare
- **The public participating is declining and replaced by managed systems traders**
- One public for futures is easy to define
 - The group responding to advanced, mechanical, space-age, effortless systems traded by supertraders who ‘won’t’ let you make critical mistakes’
 - They attend intense seminars learning to find exact highs and lows
 - Tuition refunds if the return is less than 200 percent or 5 percent drawdown
 - The ratings reports these managed futures returns are greater than stocks by a few points, but VN doubts the figures
 - For one thing only the successful funds will self-report their figures
 - For the same reason the first year of reporting results is usually the strongest

- Results are reported by the trading advisers themselves (no accountability)
- Improper weighting by initial value, selective reporting, fattening up contenders
- Computing prospective performance by a preselected group shows sharply lower returns
- Teweles - The Commodity Futures Game - the best book on Futures says VN
 - Only the brokers make money
- John Allen: Who in their right mind would invest in managed futures if they knew they would need to make a 34% return in one year just to equal the yield of a T-bill?
- Flipping investments with high vig is asking to be devoured
- **The public has unrealistic expectations about feasible returns**
- Horace Lorimer: You've got to learn not to overwork a dollar
 - 3% is a small load
 - 6% is safe
 - 10% is hard work, watch to see that it doesn't buck
 - 20%; you own a blame good critter or a mighty foolish one and you want to make dead sure which
 - 100%; you're playing the races and the horse is destined for the glue factory
- Selling debt provides the market ecosystem with an important source of energy
 - Gov dealers agree by tradition to bid on debt without commission
 - But the inventory has carrying costs
 - If the debt value doesn't go up the markets will grind to a halt
 - 30 year debt marketing day is usually the most volatile
- Robert Aliber
 - FX profit of money center banks is inordinately large relative to the capital they employ
 - These profits compensate dealers for the persistent needs of importers to buy FX and for hedgers to reduce risk
- Paul DeRosa
 - FX dealer bonuses are large but only ¼ that paid to fixed-income
 - Bank managers know it's the system that creates the profits

- Wide bid/ask and the use of limit and stop orders by slow-moving participants

Table 15–3. FX Trading Revenues 1991–1994

	\$U.S. Million			
	1991	1992	1993	1994
UK				
Barclays	384	510	267	136
HSBC Holdings	528	678	566	525
Lloyds	127	241	174	161
Nat West	239	457	359	286
Germany				
Commerzbank	30	74	75	85
Deutsche Bank	237	242	286	177
Switzerland				
OS Holding	502	626	807	777
Swiss Bk. Corp.	586	669	641	595
Union Bk. Swtz.	545	641	615	522
Netherlands				
ABN Amro	278	357	346	316
United States				
Bank America	246	300	298	237
Bankers Trust	272	331	191	–54
Chase	215	327	356	280
Chemical	289	476	468	222
Citicorp	709	1,005	995	573
First Chicago	95	110	105	42
J.P. Morgan	85	262	179	131

Canada

Bank of Montreal	118	135	132	110
Bank of Nova Scotia	86	106	112	133
Canadian Imperial	230	266	197	204
Royal Bank	233	246	221	205
Toronto-Dominion	132	134	119	113

Source: Salomon Brothers Inc.

- Dealers play the role of the house in the casino
- FX volume in 1995 was 1.2 trillion
 - $\frac{1}{3}$ is the public with the bank
 - $\frac{2}{3}$ is directly between banks in the interbank market

$$\frac{1}{2} \times 0.10\% \times \frac{1}{3} \times \$1.2 \text{ trillion} \times 250 \text{ trading days} = \$50 \text{ billion per year}$$

- Amazingly, reporting banks only make \$8-10B a year from FX business
- FX holders don't bother to hedge unless they expect at least 3% move against their holdings²⁹
- Bank profits are enhanced by a lack of a central clearing mechanism
- Customers must exit from the same house they got in
- **Therefore banks always know which way a customer will go**
- Money must be deposited in advance; most customers only want to leave enough to cover their positions
- **This allows the bank to know which way the customer will go once it has used up its available margin funds**
 - Assume a customer with \$10M on deposit as a 5% margin against the value of FX holds long positions of \$200M
 - The bank knows he has to sell dollars if he asks for a quote so they will bias the spread to a low dollar bid
 - **It's like a roach motel - easy to check in, very tough to check out**

No matter how hard I try to reduce this edge, the banks are always one step ahead of me in closing down the pass. Just before I extricate from a trade I like to call the banks and ask how much I can add to my position. "Victor, why are you going to all this trouble to jerk us around? We know you never add to a winning trade," they say. Somehow, they always know.

- Banks can also invest customer money in the Fed funds rate

²⁹ I really wish VN had gone into more detail here. I'm not sure if he's talking about the public or the dealers, but I assume dealers, and I'd like to know more about how they hedge

-

Customers have their own tricks to balance the equation. One strategy is to unload positions on several banks simultaneously, so that the banks are forced to get out at a loss when the trades start coursing through the system. To prevent this from happening, banks frequently delay making a quote until the other counterparts the customer might be trading with have indicated a direction. “You’re in line,” I often hear when I have a trade of some real size to do.

On the rare occasions when I am able to get out of a trade with a bank without an immediate loss, I invariably get a call from the sales manager at the bank the next day. “Vic, my dealer complained. We thought we were seeing your whole business. But whenever you call to ask for a quote, we hear your activity with others over the squawk box. We’re making you five-point spreads. And we’re beginning to wonder why.”

“Well, Aziz, the reason is that you make \$1 billion a year on transactions like that. You don’t hear me complaining about the 90 percent of trades I have a loss on, do you?”

-
- Banks supplement the info they have from dealers and brokers by maintaining data about the trading styles of their customers
 - Trend-follower
 - Pyramider
 - Stop-loss operator
- Dealing banks regularly talk with each other to keep track of who is long and who is short (and in this age I bet it’s practically all done with a single app or neural net)

Fixed-Income Herbivores

- Dealers make comparable bid/ask and volume to FX
- Government dealers don’t need a ‘security deposit’
- Government securities can be delivered against each other at various clearing banks or brokers, so you’re not locked into a particular position with a bank

- As a result they lack the edge of FX banks, and refuse to quote a two-way market

“Linda, Niederhoffer here; kindly offer \$10 million on the long bond.”

“We’re at 100³/₃₂.”

“I buy.”

“Bob [Dealer], you can sell \$10 million of the long bond to Niederhoffer.”

“That’s agreed.”

The broker protects himself from being exposed the wrong way on a trade by knowing the customer’s direction in advance. Finally, the time between the salesperson’s relay of the offer of a trade and the dealer’s confirmation that a trade has been made enables the dealer to guard against a move against him during the 10 seconds or so that the trade is open.

- To maintain balance customers would get several dealers on the phone simultaneously and get quotes ‘before they could react’. But the dealers quickly adapted.

Carnivores - Hedge Funds

- Mainly raised from wealthy individuals
- At the top of the heap is/was Quantum returning 35% for 35 years

Sometimes VN is annoyingly colloquial instead of explicit. For example this sounds interesting but I’m not really sure what’s going on here:

What’s the hedge funds’ secret, when they can’t make it on the bid/asked spread the way the dealers do? Certain naïve commentators attribute the return to a constant interchange between government officials and traders, which seems to mark all the successful funds. It is in the interest of governments to know what the traders are going to do, and vice versa. This helps the successful operators position themselves in the direction of the flow. The big operators look for situations where business, governments, and dealers would benefit from some market event. They then join hands and circle to the left.

- Advantages they might have
 - Big holdings
 - Former high-ranking government officials as advisors
 - A spouse who works at a central bank or a good friend at the UN
 - A regular tennis game with a central banker or a country president
- During a rising market they borrow short and invest long in equities and debt
- Dealers have uncertainty about the variation in value of the inventories they hold
 - Uncertainty about optimum quantities to hold and prices to pay and charge
 - To maintain credit access, it is helpful for dealers to lay off risk by trading with speculators

- Large hedge funds are willing to accept these risks in exchange for a profit
- Dealers maintain inventories, speculators buy goods from dealers; dealers charge a price
- Dealers conduct their business while remaining insulated from fluctuations in the value of their inventories
- Dealers can then specialize in the secure capturing of spreads instead of speculating on value
- Banks and suppliers are more willing to supply credit to dealers who insulate themselves from price fluctuation
- Dealers can engage in higher volume than if they didn't lay off the inventory risk
- Dealers total reward and reward per unit of risk is enhanced by large hedge fund activities

Decomposers

- Brokers
- Break orders into digestible sizes
- Commission house brokers solicit the order; floor traders digest it; bankruptcy specialists recycle the contract

Exchange	No. of Seats	Seat Value, Mid-1996,* in Millions
CME	625	\$0.6
CBOT	3,661	0.6
NYMEX	816	0.4
NYSE	1,366	1.2

*Midpoint of bid/asked spread.

- VN reveals the cause of his 1987 misadventure
 - After the crash he sold some bonds short against futures he owns
 - Futures closed limit up several days in a row, preventing him from offsetting his cash position with the matching futures
 - The bank mercilessly demands immediate covering despite all the tens of billions that were traded to their mutual profit over the years
 - He pays off his debt in a couple of days but by cheque after which the bank blackballs him. Despite this, years later salespeople are still trying to get him to open accounts there. (institutional memories are as short as individuals)

Rules and Regulations

- Low margin requirements (2-10%) means large amounts of money can be made swiftly in futures
- In contrast minimum margin in stock markets is 50%
- The margins need to be low enough
 - to encourage the public to turn over its trades fast enough to provide the vig that fuels the machinery;

- To allow exchange members to feed on slippage
- To encourage new membership
- Margins must be high enough:
 - To prevent overtrading; Bankruptcies that would stop them from returning to the table
 - To protect members against customer bad debts; chasing debts is not usually worth their time
 - If margins were 1%; then a 1% move would double your money your wipe you out; too much risk for a one day bet
- 50% margin makes most stock holders long-term; NYSE turnover is less than 100% a year; institutions have higher turnovers than the public; this protects them from margin liquidation, gambler's ruin, excessive trading, bandwagon psychology, broker tricks

Maintaining Rent

- VN confirms what I have long suspected; many of the traditional rules given to novice traders are actually beneficial to brokers by limiting their credit losses and encouraging maximal turnover
 - Limit losses with stops
 - Bulls and bears make money, pigs get slaughtered
 - Cut losses short
 - Don't fight the trend
 - Always trade at the market
- Using stops has some commons sense but it allows the reducers on the floor to make money by moving prices to levels where stop orders will be triggered; "running the stops"
- When you get stopped out you take your losses at an 'acceptable' 'predetermined' level so your brokers are protected against your credit risk
- VN has never used stops even to bail himself out (though maybe he should have?)
- **Having a fixed rule to exit provides my adversaries too great an advantage**
- Instead trade with a low enough percentage of money at risk to avoid disaster

Public Bullishness

- The public is psychologically predisposition to take the bullish side of a trade; especially new market entrants
 - Optimistic bias
 - Predisposition to ownership
 - Going short is high friction, with borrowing costs, dividend payouts, difficulty of finding sufficient stock
 - Seems arcane and sinister to the newbie; "selling something you don't own"
 - **Broker limitations on shorting**
- VN tells the story of the Hunt brothers silver corner once again
 - He lost millions and would have been entitled to some compensation from the lawsuits that followed but he didn't keep his records (7 years after)
 - His broker had gone out of business and so they didn't have records either

- Keep your records for a long, long time, advises VN, especially if you have a big loss as you never know when the dust will settle
- In 1993 there was a similar story with the copper market
 - A rumor arises that a Japanese trading firm was cornering copper
 - The LME puts a restriction on the difference in price between the near month and the distant month contract
 - David King, chief of LME: It's not about protecting anybody, just ensuring that prices are what people expect them to be.
 - This works until May 1996 when several 'large carnivores' short copper at \$1.30 a pound
 - Sumitomo corporation is shown to have lost \$2.6B from a rogue trader named Hamanaka, and copper falls 40% next month. Before that Sumitomo had said Mr. Copper (Hamanaka) was "the most honest person I have ever met."
 - Reforms designed to prevent this type of thing from happening again may cripple trading, VN fears

Competitive Exclusion

- No 2 species with similar styles can occupy the same niches, nor can two species that are completely competitive co-exist.
 - Fruit flies and paramecia
 - Chicago and NY gold
 - CBOT stock futures and IMM stock futures
- Coexistence is possible by separating into niches
 - Giraffes (eat leaves in tall trees) and Wildebeests (eat grass) in the Serengeti
 - CBOT Treasury bonds (3 month rate) and Eurodollar futures on IMM (30 year rate) traded just 7 blocks apart
- A constant stream of new money going into the system is needed to keep it going
 - Net money coming in must at least equal net money going out
 - The public is the basic producer that must provide this new energy
 - There must be a constant stream of new members coming back to take up the slack caused by those who have fallen
 - Net contributions must provide for the costs of running the system and the profits that the higher levels take out
 - The consumers (banks, hedge funds, brokers) must not get greedy because if they take out more of the public's resources than can be refreshed from new entrants, the system will diminish its own food supply and hinder itself through excessive competition, which can lead to extinction
 - **There is therefore 'close commonality of interest' between predators and prey**
- Homeostatic Functions
 - Homeostasis == negative feedback
 - Keeps organisms in balance, internally and externally
 - CFTC and NFA == white blood cells
 - Price moves in markets take on the role of temperature stabilizer

- Nobody knows what the equilibrium level is until the morning after
- Interacting markets, activities of contrarians, value investors are the main forces for market homeostasis
- VN condescends to dismiss Soros idea of a supranational body to govern markets

It is good thus to try in imagination to give any one species an advantage over another. Probably in no instance should we know what to do. This ought to convince us of our ignorance on the mutual relations of all organic beings, a conviction as necessary as it is difficult to acquire.¹³

-Charles Darwin

Finale

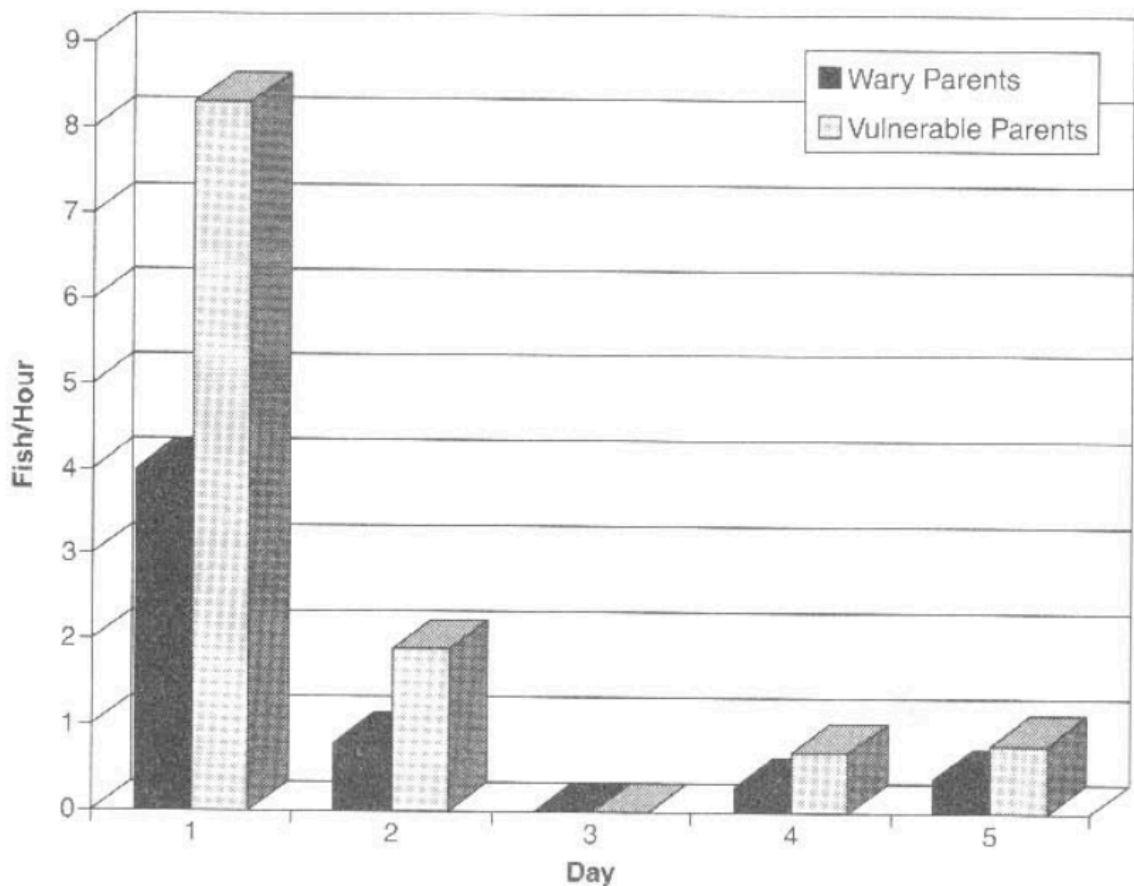
VN chooses to finish his book with a fairly eclectic and seemingly unrelated series of topics.

Lessons from Fishing

- Take account of ecology. Where does the other side live and what do they eat? Consider their rhythms; synch your activities with the speed of the currents
- Everything is hooked together; "A man may fish with the worm that hath eat of a king and eat of the fish that hath fed of that worm." - Hamlet by Shakespeare
- To know how good you are, enter a contest; but keep in mind that completely different techniques are appropriate here from those that win in the normal fray
- Be a contrarian, above all; once you hit a winner, you're unlikely to hit again in the same place
- The weather affects everything; easiest pickings at full moons
- The weakest prey are the easiest to catch; when the battlefield is red, prepare to reel in the biggest winners
- Stay calm. Keep emotions in check. The time for exhilaration is after you've bagged a winner. Reflect on what you did right or wrong; Adapt a scientific approach, keep records; Change something if you're doing badly; Learn from the legends
- Cycles are always changing

Steve Stigler

- You get different results when the trend followers have made money for a few months in a row



Angling Vulnerability of Largemouth Bass

-
- The chart shows the results of different groups of large-mouth bass, one group that is susceptible to being caught with artificial lures, and the other not
- When the two groups spawned, the 'wary' offspring were caught half as often as the 'vulnerable' fish
- Do you get what he's saying here? I'm not sure I get it.
- VN says Martin, his grandfather, and Artie, his dad, were bad bargainers; so they're in the 'vulnerable' fish group?
- Artie was uncomfortable with haggling and VN feels that has also failed to ask for his fair share in business
- However now he bargains for everything and it carries over into his personal life
 - If the speculator cannot bargain for the best deal they must ask a trusted friend to 'carry the ball'
 - When asking for a market quote he contacts several dealers to see which way they are leaning
 - At a certain point prices converge

Dealing with Dealers

- Dealers like to trade against VN once they know which way he's leaning
- If he's planning to sell now, he leaves a limit order to buy on the books
- If current bond price is 101.08 and he intends to sell at 101.31, he will leave an order to buy at 101.01
- He then calls several dealers to get a market; asking each of them to tighten the quotes, never accepting too wide a spread
- Then he chooses the best one, a process which takes 2 seconds
- The extra 1/100 of 1% he saves in face value good for at least 50% of his total profits over the course of an average year

Modern Panic

- VN tells the story of selling in the July 16, 1996 flash crash
- VN disparages (rightly) Japanese candlestick patterns
- VN disparages advanced mathematical treatises, catastrophe theory, genetic algorithms, chaos theory, fourier analysis, nonlinear differential equations, and neural networks (all this in 1997. What is the big new tech that hedge funds have been exploring in the past 25 years??)
 - The techniques were great retrospectively but invariably had nothing to say on a predictive basis
- VN brings up LoBagola again.
 - As soon as he gets out at the top of a price move it goes right back where it came. The story of LoBagola is an epic and unlikely tale, but the gist is that elephants always go right back the way they came just like that price move.
 - [One problem is that LoBagola is a complete fraud.](#) Can we trust his statements about elephants? Did VN not have access to the internet before he wrote this book? A little research does suggest they do follow the same migratory routes.
 - VN calls his analysis for dealing with sudden catastrophic prices moves LoBagola analysis.
 - VN reasons that if he could just catch one of these giant moves with a reasonably sized position it would achieve his lifetime's ambition for wealth
 - He gets clues by listening to the floor
 - Monkeys chattering: refrain from trading for a while
 - If the floor sounds like a 7th inning stretch at a baseball game, a trade is warranted
 - When the elephants are trampling: sits on his hands
 - Wait for the funnel, the eye of the storm to pass
 - After elephants destroy an area, other species descend to pick up the debris
 - He plays the fixed-income and commodity markets of a currency that just 'LoBagolaed'
- When interviewed in 1994 after his *annus mirabilis*, he attributes his success to LoBagola analysis
- But there is a problem

- Each of these LoBagola moves that retrace have numerous countermoves that start to retreat, but then turn around in the direction of the original roll
- Fakeouts
- Some moves are so abrupt they are over before you can follow them
- There appears to be no systematic way to profit from them
- The one thing we know about elephants on a roll is that they will return by the same path **at some time**
- **The patient native sets his traps where he knows they will retrace their steps**

Valuing the Goods

- In the most roundabout way possible, VN tells us that he wishes his approach to buying stocks was based more on fundamentals;
- he has a tendency to ‘buy copper in London when Hong Kong stocks go down 3 days in a row’ or sell wheat in Minneapolis when the price of rice is down in Tokyo.
- He finds that buying stocks based on the ValuLine price/book ratio gives mixed results and prefers his ‘futures trading based on the numbers’
- Value stocks look good on paper but if the distressed merchandise doesn’t sell, it’s good to fall back on a reliable money-making program

Chinese handball

- Requires a bounce on the ground before hitting the wall
- Using a limit order slows down the game in the market too
- A market order in a fast-moving instrument ‘frequently’ leads to a fast rebound against
- A limit order doesn’t win as fast but slows down losses
- VN doesn’t trade NASDAQ stocks because of the wide spreads \$0.40 on a \$20 security.
- Giving up 2% to get in/out of a trade before commissions is ‘loathsome’
- Using a limit order to capture the spread in his favour doesn’t work “because limit orders for the public are not given priority, even if at more favorable prices than dealers’ bids and asks.”
- It turns out the reason for these wide spreads is fear of bullying and humiliation by fellow dealers

The way these wide spreads have been maintained now emerges amid much publicity. If a dealer dared to post a 1/8- or 1/4-point spread instead of the standard 1/2-point spreads typical for all but the most active stocks, he was subjected to a variety of tortures. The narrower market was referred to as a Chinese market with all the opprobrium the word connotes to children in their juvenile pursuits. The trader who set the Chinese market was subjected to humiliation in the form of anonymous phone calls, not unlike the prank calls children make. In one case, reportedly taped by the SEC, the anonymous caller “in a phony Chinese accent ordered chop suey, moo goo gai pan, or other Chinese food, in an apparent allusion to the understanding among market makers not to make ‘Chinese markets.’”²

-
- On his dad’s deathbed he reassures him that he has everything (that is to say, unknown unknowns) under control in his business. Heartbreaking on the page, but even more so knowing what we know in the future!
- VN disparages commodity trading seminars; nobody with a system worth selling would sell it; and even if it did work, the knowledge that makes it work would be stale by the time you got wind of it

Trading Susan

- If VN gets out of synch with the market his trading rhythm goes awry
- So he must keep in touch with prices 24h/ day
- He even brings in a portable screen while his wife is in labour, trying to trade out of positions on a cell phone
- “Successful speculation is nothing more than a scientific, systematic, and economical way of hastening the inevitable. There is no secret to it.”
 - Any techniques he could share would be outdated by the time we read them
- Basing trading strategies on blind faith in a guru is high on the list of mistakes
- However VN relies heavily on an in-house guru, Steve “Bo” Keeley, who is also a hobo
 - Hobos ride the railways illegally moving from job to job
 - Tramps don’t work but also ride the rails illegally
- VN and Bo use railroad car loading statistics, an indicator that has fallen into disuse
 - The hobo:tramp ratio is a good measure of the employment situation
 - Bo sends VN a bulletin in Feb. 1996 that freight cars were going through key locations at double the usual rate; VN decides to remain short the bond
 - Shortly after, bonds drop 3 points
- Bo is also a veterinarian
 - When dog owners anticipate good times they buy richer food for their dogs
 - This causes cavities and gum problems
 - Again based on Bo’s intelligence that vet business is brisk he shorts bonds
- Soup kitchen lines length; long lines == bad times
- Amount of food in dumpsters

- A shift from coal to oil cars says that energy is on a roll
- Auto carrier trains; sticker prices show the direction of inflation
- The size of cigarette butts on the ground; the longer they are the better things must be as fewer people are picking up discarded butts to smoke the remaining tobacco

Code of Brighton

- VN returns once again to the topic of racquet sports, this time to argue for the libertarian ideal of lower or no taxes
- Politicians are professional gangsters; their goal is to pluck as many chickens without too much squawking
- With this philosophy, during the [Peso Crisis](#) VN anticipates that US politicians will not be interested in further devaluation of the peso and he buys Mexican T-bills to great effect

The book concludes with a masterful paraphrasing of the chaos experienced in a long two minutes of a 'typical' market panic at his home office. I can't do it justice; you'll just have to read it.

Review:

Despite its problems, this is a wondrous book. Written nearly 7 years before 'Fooled by Randomness' but with at least as much wit and clever insight. This is a damn fine read if not a masterpiece of speculation education. The only reason you might not think so is if, like me, you've already read 'Fooled by Randomness' and a bunch of similar trading books which have given us much of the same background, but assuredly not in as charming a package.

This is good news for us, because it means **we are making progress in our journey and can start to dismiss books that go over the basics**. We are looking for specialist knowledge now. More technical knowledge.

One criticism I have is that the book was written with goals other than to educate. For Niederhoffer it's clear his main goals were

- To write an entertaining story (fine by me)
- To show off his knowledge not just of markets but of *everything*
- To honour his family

It's mostly in b) and to some extent c) where the reader might wish he had cleaved closer to brevity.

Actually there is one other reason you might doubt the value of this book. **Niederhoffer blew up not just one hedge fund, but two**. His own fund in the '97 mini-crash, by investing in risky Thai stocks and ~~somehow~~, ([actually Taleb told us but I forgot](#)) Matador partners, in September 2007 (before the frenzy of the economic crisis?) with a loss of 75% of its value. This is what he's remembered for, unfortunately, more than his brilliance.

<https://www.newyorker.com/magazine/2007/10/15/the-blow-up-artist>

https://en.wikipedia.org/wiki/Victor_Niederhoffer

So what do we make of this? Does it mean VN doesn't know what he's talking about? I don't think so. I think there is **a big difference between knowing a thing and doing it**. VN knew he shouldn't gamble. He also knew he couldn't become a legend without plunging. The era of plungers may sadly be behind us. What made Soros great? Maybe his back, but also he was early; he was a pioneer before the computer age. VN possibly knew this but made the attempt anyway, to his peril.

I also think that some personalities simply have to live close to the edge, touch the burning stove, see how underwater they can get without drowning, and eventually they find out.

The other lesson, maybe even more important than anything we get from the book, is that **spurious correlations should not be trusted**. VN might have had too much faith that what he saw in the past was a generalization of what would happen in the future. Recall Taleb: empiricism is not the same as deduction.

Finally, recall the lesson of Solon: Count no man lucky, until he is dead. VN isn't; so there's still time for a comeback.