

Why Speculators Win

There is a common belief that only 10% of people who set out to become traders actually achieve their initial desire for consistent high returns over the long haul. Objective data to verify this belief would be extremely difficult to obtain in practical terms. In fact I haven't seen any hard data on it, but an application of the Pareto Principle: 20% of the traders take 80% of the money seems to confirm the belief.

Then the question arises why a few win and most don't? Furthermore what do the few who win big do that the crowd of non-winners doesn't do?

As a success coach of traders I have worked with clients in all parts of the trading success spectrum. One feature I have noticed about my supertrader clients is that they go about their business from the perspective of speculation in a way that is different to the majority. Put simply the supertrader identifies, accepts and manages (that is trades) positions that represent no more than **conjectures** about the future. My concise Oxford dictionary defines conjecture as "formation of an opinion on incomplete grounds, a guess."

Now in dealing with the future we know one thing for sure: the future is unknowable. Anything can happen, from what you expect, to its exact opposite, to something completely different. For example in everyday life an event could happen in the next instant that could change your life forever. You might receive news of an unexpected inheritance from long lost relative, or on the other hand some terrible news like a fatal accident of a loved one. Most people don't dwell on this existential reality and deal with issues as they arise.

But in the business of speculation the trader must not only deal with the uncertainty of an unknowable future but also embrace it. Why embrace it? Because taking positions of uncertainty involves risk. The speculator's return is directly proportional to his or her capacity to accept and manage risk.

Trading has an additional dimension. Unlike in life, in trading there is an active counterparty to your stance about the future who backs the exact opposite to your view and requires you to pay up if you are wrong. Of course if your speculation is right you get paid.

An example

The price of a security is currently \$5. The speculator thinks (conjectures) the security is really worth \$10 in the future and so therefore buys. This conjecture is based of necessity on the extrapolation of very incomplete and tentative information, perhaps fundamental, and/or technical, or even intuitive. Nevertheless the position contains a lot of risk because if the crowd thought the security was worth \$10 then what would be its price now? Yes that's right: \$10. So **the speculator thinks and acts differently to the crowd**. A speculator's work is proactive and counterintuitive.

It is apparent that the speculator who buys at \$5 and sells at \$10 profits more than those who bought at \$6 or \$7. At these prices buyers are becoming more comfortable, it seems safer and so the crowd begins to join in. You can see that **if you are part of the crowd then your opportunity for huge profits is diminished**.

The speculator acts before the crowd. This means that the speculator buys when there is very little interest in the security and when it seems unsafe to buy because there is scant information that confirms it will go to a much higher price, and sells when the crowd is buying wholeheartedly because it seems to be safe to buy because the information about the quality of the security has become available and after all everybody else is buying, except speculators who are selling to them.

In essence a speculator prefers to buy from distressed sellers and sells to panic buyers. To confirm this, in a period of general up momentum have a look at the SPI when the Dow is down 150 points overnight. The overnight Sycom is down and the SPI opens 20 points lower. Everybody is expecting a bad day, except for a speculator who buys for the very short term into a pocket of real weakness just after open when the public wants out. The speculator buys knowing the odds are in his or her favour.

All this is another way of saying that speculative profit is in buying low and selling high. The corollary is buying high and selling even higher, but in doing this some of the profit potential is extracted from the trade as a result of the quest for more certainty. Of course the converse is true for opening on the short side: sell high, buy low.

Well this raises the obvious problems if not occupational hazards associated with successful speculation. Speculators are often going to be wrong, and speculators are often too early. And how do you handle the winners wisely? Again supertraders embrace these features of their job and turn them into positives.

On being wrong

If there is a probability of being wrong then it must be acknowledged and dealt with.

A gambler takes a position that buys in the example above at \$5, and then leaves it to chance. The gambler can potentially lose the lot. On the other hand, because it is only a conjecture, the speculator will have a predefined point that recognises that the position is wrong and furthermore indicates it may lose big time if nothing is done about it. So the speculator will only be prepared to stake a small amount to confirm the conjecture. If this is say 1% then the speculator enters the position at \$5 prepared to risk 5 cents for a potential reward of \$5, if it goes to \$10. But at \$4.95 the position is closed out without procrastination.

A key function of speculation is the preservation of capital in this high-risk business. This means that the speculator is not attached to any one conjecture. If his or her conjecture is wrong, the loss is stopped to transfer the risk onto somebody else, and he or she calmly moves on to the next opportunity.

On being too early

Since the speculator must of necessity operate before the full range of information about the security becomes available, he or she will inevitably enter some positions too early. What this in fact means is that the speculator will be stopped out at \$4.95, and of course the price of the security could then reverse and move rapidly towards \$10.

What is the speculator's task in this case? Give up? Lament the vagaries of markets? No, the task is to reenter the position at \$5.00. Market reentry is a powerful tool in the hands of an astute speculator who knows that there is a good chance that the original conjecture is correct but premature.

On the other hand, what if the security exited at \$4.95 falls sharply? This is to the speculator's advantage too. Instead of buying at \$5 the market is providing the opportunity to reenter at a very much lower price, if its eventual ascent to \$10 is still indicated.

And of course while waiting patiently for this security to reverse, other opportunities are identified and exploited.

On handling winners

While playing great defense is important if the position is wrong, the crucial element in this business is to effectively process those conjectures that turn out to be right. A different mind set is required for handling winners than from stopping losers.

A supertrader, in a measured and deliberate way, adds to winning positions so that he or she has more at stake in positions that are proving to be winners. How do you know that your are on a winner? Your account is increasing. While there is a temptation to take the profit just because it's available, this is the signal not to close out (unless the position starts to retrace and hits a trailing stop) but actually to buy more.

Handling winners is more than passively riding them. The job is to extend and manage the winning position in full cooperation with the rising market. Again patience is the key, waiting for information to become available to the crowd so that for it buying seems quite safe. The speculator is in position to provide the crowd with what it wants.

The winning trade will eventually have to be closed to book a substantial profit. The profit from successful speculations well and truly covers the cost of fossicking for winning positions as well as providing a handsome return for effectively managing risks, as the speculator goes about his or her business.

In our example, the overall odds for a successful outcome are 100 to 1 even without adding to the position. (Buy at \$5 with a 5 cent risk to sell at \$10 for a \$5 profit). No wonder people are attracted to the leverage of speculation! With odds like this you certainly don't need to win very time to do well.

From theory to practice

This article has covered the cognitive foundation for the extraordinary returns available to the very best of speculators.

Each supertrader that I work with applies this information in his or her unique way to develop an effective niche in terms of time periods and trading instruments. For some holding a large position with a 5-point risk on the SPI for 2 hours seems like an eternity. Others hold positions in markets like Beans for months. But they all operate their speculation in a proactive, businesslike and detached manner.



In practice it is not analysis or trading skills that bring success, although they are quite important. What is essential is the **transformation** of the **mental edge** of the speculator to synthesise his or her analysis and trading skills, to **permit** the achievement of the superior returns available from the successful **management** of risk and uncertainty.

The attributes for excellence in the business of speculation are similar to those required for outstanding success in many fields of human endeavour. **To excel one has to be different, to be disciplined and to relish the opportunities available.** Fortunately, as in other fields, these attributes and the essential mental qualities can be shaped, guided and sustained through a successful **coaching** relationship.

Chris Shea is a psychotherapist and success coach who specialises in assisting traders at all levels of development. Refer to www.themarketcoach.com
Contact Chris by email chris@themarketcoach.com or phone 07 32784066