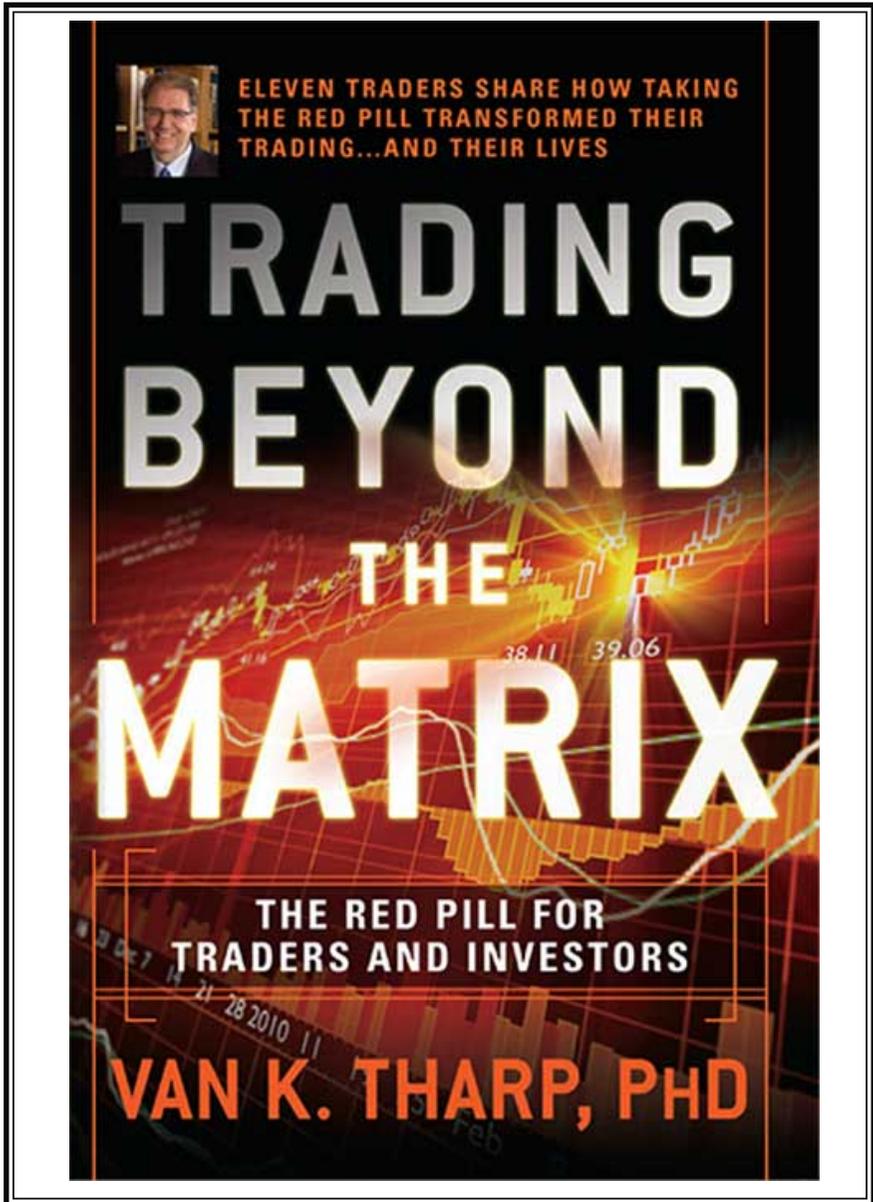


Trading Beyond the Matrix

The Red Pill for Traders and Investors

Mini-Version



By Van K. Tharp, Ph.D

Preface

UNDERSTANDING TRANSFORMATION

Van K. Tharp, PhD

I've been coaching traders for nearly three decades. Occasionally, someone asks, "If Van Tharp is such a good trading coach, why doesn't he just trade?" That statement makes a big presupposition: namely, that the money one gets from trading or even trading success is the be-all and end-all of life, which certainly is not the case for me. My mission has always been to help people transform for the better; I just happen to do it through a trading metaphor. I thrive on the comments I get about how I've changed peoples' lives. For example, here are a few of the comments I've gotten recently:

Your program is not only helping me in my trading, but also in my business. I've been much more peaceful and open ever since I starting working with you. It's helped me with everything I do in my daily life.

— *H.T., Atlanta, GA*

Before taking your workshop, my life was filled with wants. After the class, I am more in line with my inner Self, and I just want to be. In addition, prior to the workshop, I scored 20 on the Happiness Test. After taking two classes, my score increased by 63 points to a nearly perfect 83. Thank you.

— *T.H., Franklin, VA*

It's difficult to say how big an impact you've had on my life because you made the change so deep that everything has changed. This is a beautiful gift, and I want to thank you very much for everything you have done for me! . . . I'm not alone

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anymore, and I've found the path of true happiness. I know what my life's mission is and what I have to do to follow my bliss. I feel like I'm starting a new life again.

—D.M., Quebec City, Canada

After attending your workshop, I came back feeling like any dream was possible. When I started applying the techniques to my sales job, I had my biggest commission month in my 27-year sales career. I made \$200,000 for a month's work—more than triple my prior career high. Now I can't wait to start manifesting in my new trading career.

—E.M., Washington, DC

To make a long story short, my life changed from a chance meeting with a soft-spoken teddy bear named Van Tharp. I jumped from the life path of financial fear to a life path of fun and adventure. The changes I have gone through have improved both my marriage and my ability to think.

—J.G., VA

Such comments about transformation are the engine that makes The Van Tharp Institute (VTI) run, because, as I've said, our mission is one of *transformation through a trading metaphor*. I thrive on it and my staff thrives on it.

Recently, I realized that we actually take people through three levels of transformation: (1) transformation of the trading game; (2) psychological transformation around beliefs, stuck feelings and conflicting parts; and (3) what I call Level III transformations, which occur when you make enough transformations that you actually produce a major change in your consciousness.

After the three levels of transformation became clear to me, I better understood what people need most to succeed. This book is designed to convey that information, with a number of chapters written about each level of transformation.

But let's talk about the title of this book, *Trading Beyond the Matrix: The Red Pill for Traders and Investors*. When I first saw the movie, *The Matrix*, I loved it, not for the action but for the metaphor. In fact, I recently watched it again and discovered that I didn't remember a lot of the details, just the metaphor.

The metaphor suggests that we are all programmed. We live in a world of illusion shaped by our programming. And at some level, we seem to know that, and we seem to know that there is something

better. At this point, you have a choice. You can take the blue pill and go back into a comfortable sleep where nothing changes. In this case, it means put the book back on the shelf and do nothing. Or you take the red pill and, as Morpheus says in the movie, “see how deep the rabbit hole goes.” Read this book, do what it suggests, and your life will change forever.

We really are so programmed by our beliefs, which we get from our parents, our churches, our schooling, our friends, and the media. We believe what we believe, and that tends to shape our reality. We’ll explore that extensively in Chapter 7 of this book. However, once you take the red pill (hopefully this book, for you), you can begin to explore whether or not those beliefs are useful for functioning at a high level within the Matrix.

In the *Matrix* movie, Neo actually gets reprogrammed like a computer, but you can do the same thing by becoming aware of how your beliefs program you and whether or not that programming suits you. And as you start to do so, you begin to function as at a very high level within the Matrix.

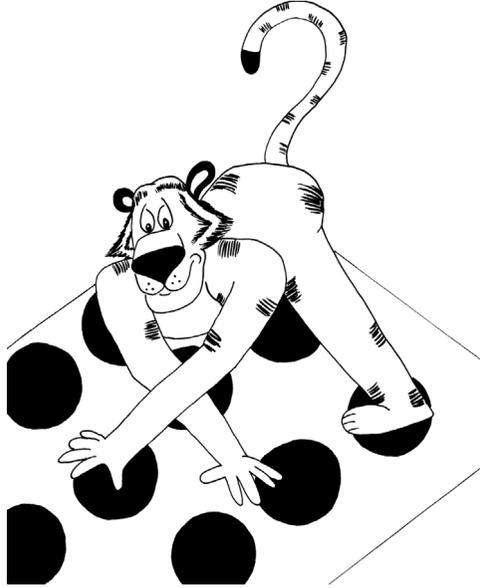
So now, let’s look a little more closely at the three levels of transformation.

Level I: Transformation of the Trading Game

The first level we offer is transformation of the trading game—from rules that assure big money wins to rules that give the astute trader a huge edge. These new rules consist of the Tharp Think concepts I require everyone in my Super Trader program to know and understand as the cornerstone of their training. These rules are given in Chapter 6, the summary of Section I of this book. Most of them are not my rules; they come from my modeling work with great traders. But I don’t know of anyone else with a program that emphasizes all of them.

In one of my advanced workshops, I teach the concept that we all play “games” in life. A game can be defined as any interaction consisting of two or more players with a set of rules that generally define how the game is won or lost. I’m using the concept of the “trading game” to symbolize a big-picture description of all aspects of trading.

I believe the financial markets are part of a huge game, and at the top level—where the rules get set, made and changed—there is Big Money. Big Money makes its own rules and profits no



We all play games in life.

matter what you or any individual trader does; they are much bigger than that. Big Money controls the U.S. government. You might have noticed, for example, where U.S. Treasury leaders so often come from and where they go afterwards. The last six secretaries of the treasury have included two people with strong ties to Goldman Sachs, a former president of the New York Federal Reserve, and a chief economist at the World Bank. The other two were both former company CEOs. Much controversy has been associated with these men, but it is generally ignored by the public.

In addition, the Federal Reserve, which prints dollars, is not government owned or controlled. Instead, it is privately owned by some of the richest people in the world.¹ It's interesting to note that the U.S. income tax and the Federal Reserve were created almost simultaneously. And right now the Federal Reserve is stimulating the economy by giving money to the very people who own it—the big banks.

Big Money has also created a two-party political system in which people argue over everything except what is really going on and what is really important to the future of the United States—something that might be true of almost every country in the world.

The real issue today, for example, is government spending. But the political parties tend to argue over whether or not it is fair for the rich to pay hefty taxes.

This game is a little like the programming in the *Matrix* movie. We're all programmed by our beliefs and our beliefs all say that we should play this game. And that means that you need to fight the crowd in order to function at a super human level within the Matrix. Everyone is a part of the system because they adopt the beliefs of the system and thus support it even if those beliefs do not support them.

As Morpheus says, "most people are so inured, so hopelessly dependent on the system that they will fight to protect it." Does that sound familiar?

Trading is not easy to do, but becoming a trader is easy. There are no obstacles whatsoever to anyone opening a trading account. My wife, for example, currently has a trading account with less than \$100 in it.

I've said for a long time that if trading were easy, Big Money would monopolize it. They'd do so by making the entry requirements so steep that it would be impossible for an average person to trade, perhaps through an education and exam system that would weed out most people. Today, for example, brokers have to take a Series 7 exam even though passing this exam has absolutely nothing to do with success in the market.

If you want to know Big Money's rule, just watch the financial media for a week or so. They'll imply that:

- Selecting the right investment (i.e., picking the right stock) is everything.
- When you find the right investment, buy it and hold it for the long term.
- You must spend a lot of time analyzing the market to find the right investment.
- You should listen to experts for advice, including newsletter writers, brokers, and investment gurus on television.

My experience indicates that those old rules are what cause most people to be net losers in the markets. Through my modeling work with top traders and investors, looking at what they do and how they think, I've come up with a new set of rules. We call these

rules Tharp Think. Let me repeat: they are called Tharp Think, not because I invented them, but because we are the only organization I know of that emphasizes all of them collectively.

The new rules consist of four primary rules, but we've broken them down into numerous technical and psychological rules. Level I transformation is probably the most basic transformation you must make as a trader/investor. We will be exploring many of the new rules and concepts in Section I of this book.

Level II: Understanding the Matrix and Reprogramming Yourself

I love the premise for the movie *The Matrix* because “the Matrix” is much more real than most people realize. When you name something and assign adjectives and phrases to that name, you give meaning to the world (e.g., dog, small dog, hyperactive dog, dog that would be a good pet, dog that needs discipline-training classes). We shape our entire world by our words, thoughts, and beliefs. This is the Matrix.

And to change it, you have to take the red pill.

You take the blue pill, the story ends; you wake up in your bed and believe whatever you want to believe. You take the red pill, you stay in Wonderland, and I show you how deep the rabbit hole goes.

When you take the metaphorical red pill, you learn that the whole world is shaped by your beliefs and open up to an amazing world of possibility. You're free to transform yourself by releasing nonuseful beliefs and adopting useful ones.

My intention for this book is that it be a red pill for traders and investors. You can put it on the shelf, go back to sleep, and believe whatever you want to believe about what it takes to be successful in the market, or you can read it and find out just how deep the rabbit hole goes for you. It's your choice.

There are several things you must do as you go down the rabbit hole. First, you must examine your beliefs. You don't trade the markets, you trade your beliefs about the markets; and if your beliefs are not useful, you're in big trouble. Everyone has beliefs about the market, including nontraders and noninvestors, and if you really examine them, you'll find that most are not that useful.

Examine your own beliefs. What does each belief get you into? What does it get you out of? What happens, for example, when you believe that the secret to market success is to be a good stock picker? Who would you be if you didn't have your beliefs? Are your beliefs useful? Do they serve you?

If one of your beliefs is not useful, you can always replace it with another, more useful belief. This is easy to do—unless the old belief is charged with emotion. Emotional charge will hold a belief in place, and you cannot release it until you release the charge. Consequently, another part of the journey down the rabbit hole is examining the charge stored inside you that holds many of your nonuseful beliefs in place and releasing it.

As you travel down the rabbit hole, you meet a lot of parts or different aspects of who you think you are. For example, you might have the following parts:

- A *perfectionist* part that won't let you do anything until you're sure things are perfect. This part's definition of *perfect* might be making money on every trade. Not very useful, but people do have parts like this.
- The *risk manager* who cannot stand to lose money and who is always afraid to do anything that might cause him to lose money.
- The *researcher* who is always trying something new. This can be useful to a trader, but it can also be distracting.
- The *excitement-seeking part* that wants to do things in the market that provide you with big thrills. Good trading is usually boring, so a part like this is probably not helpful at all.
- You could have *a part like your dad* that criticizes you whenever you do anything wrong. If that sort of dad is in there, you probably feel put down and often criticize yourself in order to protect yourself from your dad's criticism.
- Perhaps *your mom* is in there, and she's always saying, "Please get a real job."

You probably have thousands of parts like these. Each part has its own set of beliefs. Each part has a positive intention for you. But you can probably see that parts could become very conflicted and lead you to the point where you cannot do anything. Thus, one of your jobs as a potential Super Trader is to clear out the crowd and bring your mind toward oneness and serenity.

Much of our education for traders involves this sort of work. Imagine looking at all of your trading beliefs and eliminating those that don't help you win. On top of that, imagine eliminating all the beliefs that limit you. Now imagine eliminating all the beliefs about the universe that seem to indicate that you can't win because the universe (or God) is against you. Lastly, imagine getting all of your parts unified so there is no conflict inside. This is how powerful personal transformation can be. In Section II of this book, you'll see the impact of various types of transformation at Level II.

Level III: Trading Beyond the Matrix

There is one other aspect of *The Matrix* that is really fascinating. Toward the end of the movie, Neo is able to step beyond his programming. He is able to do things that you shouldn't be able to do within the Matrix. And that brings us to the final level of transformation: trading beyond the Matrix by changing your level of consciousness. Here consciousness refers to your level of awareness. And you might raise it if you actually transform or eliminate 1,000 beliefs. It might happen if you transform 50 to 100 parts of yourself to move toward unity.

However, for some people it might be even easier than that. Transform five significant issues that have dominated your life, and you understand the process and can go on to accomplish anything. But let's look a little deeper into what raising your level of consciousness might mean.

The late David Hawkins was one of the most successful psychiatrists in the world. He had a very high level of consciousness and performed miracle cures on his patients. He eventually closed his practice to pursue a Ph.D. in psychology, his thesis on measuring the levels of human consciousness. Much of his thesis was then turned into a popular book entitled *Power vs. Force*.

In *Power vs. Force*, Hawkins describes human consciousness using a log scale from 1 to 1,000, with 1,000 being the highest level of consciousness achievable by a human being. Hawkins postulated that only a few (e.g., Jesus, Buddha, Krishna, etc.) ever achieved the 1,000 level. He goes on to say that, for much of the past 5,000 years, human consciousness as a whole has been just below 200—the level that separates the positive from the negative. According to Hawkins, Gandhi² had a consciousness of 700 and was able to

defeat the British Army, whose collective consciousness was 175. That's the power of the log scale difference between power (high consciousness) and force.

Raising your level of consciousness doesn't just help Gandhi, it can help you as a trader. If you are trading at a low level of consciousness, you are probably trading out of fear, greed, or desperation. Now imagine how that would change if you were to trade from a level of acceptance or peacefulness. The difference would be enormous.

One of our goals at the Van Tharp Institute is to help traders take large leaps forward in consciousness. Imagine again the impact of getting rid of around 1,000 to 5,000 nonuseful beliefs in a year. That probably would raise your consciousness several hundred points. A number of my Super Trader candidates have had such increases in their consciousness, and in Section III of this book, I'll share some of their stories.

Your Personal Application of This Material

Some people might read this book with the idea that it constantly talks about our various workshops and programs. That's inevitable, because these Super Trader journeys were all taken by people I've worked closely with during the past five years. They are mostly Super Trader candidates (meaning they are still in the Super Trader program at the Van Tharp Institute) or graduates of the program, which means they're going to talk a lot about what they've done.

However, this book is mostly about psychological transformation, and every technique we use is clearly described in this book. Consequently, there is nothing we do, at least in the Super Trader program, that you couldn't do on your own.

You might have beliefs that suggest that key information is missing, or that it isn't for you, or that it doesn't fit you. This book will probably stimulate a lot of other beliefs for some of you. As you read, you may say to yourself, *I don't believe that*, in which case you'll be right—because that particular belief actually shapes your reality. However, you should make sure you at least run such beliefs through the belief examination paradigm given in this book before deciding to hold onto them. You'll probably find that most of them limit you, stop you from action, and block you from true happiness.

First, you will learn the technical basis of Tharp Think. Those principles are clearly listed in the introduction to Section I. In fact, the principles in Section I are clear enough that you should be able to design a great system that fits you for one particular market type with no problem at all, unless you have psychological issues blocking you. For those of you who don't think you can do it, the psychological principles are given in the introduction to Section II.

Second, you'll learn how to determine what parts you have in Chapter 9. Exercises are given for doing that in the chapter. Once you understand which parts of you control your trading, it's a fairly simple exercise to get each part to give you 20 beliefs that you can run through the Belief Examination Paradigm. See Chapter 7 for a description of the Belief Examination Paradigm.

When you've run 200+ beliefs through that paradigm, it should be easy for you to determine which ones are useful and should be kept and which ones are not useful and should be eliminated. And you'll be able to easily change any nonuseful beliefs—unless they have a lot of charge stored in them.

If you have a lot of beliefs with charge in them, the feeling release methods in Chapter 8 are very clear. You should be able to apply them immediately to your charged beliefs.

My chapter about following Internal Guidance also has step-by-step instructions. To develop a strong Internal Guidance, you need to eliminate any parts that do not trust your Internal Guidance—something you can do using the Transformational Meditation Technique illustrated in Chapter 11. In addition, steps are given for deepening the bond you have with your Internal Guidance in Chapter 10.

Section III contains a number of chapters in which some of my students describe their transformational journeys. These should help you understand how important it is to take this kind of journey and what could happen to you after you take the journey.

Finally, each section ends with a practical application chapter. You will get specific Tharp Think concepts that apply to that section, specific steps you can follow, and even a question-and-answer section pertaining to the material in that section. These checklists are the same checklists I give my Super Traders, and I seriously debated whether or not to include them. However, my mission is about transformation, and my expectation is that it will have some sort of transformational effect on the reader. If it does, then I've accomplished a lot.

SECTION

TRANSFORMATION OF THE TRADING GAME

UNDERSTANDING THE BASICS

Van K. Tharp, PhD

The first level we offer is transformation of the trading game—from rules that assure big money wins to rules that give the astute trader a huge edge. These new rules consist of the Tharp Think concepts I require everyone in my Super Trader program to know and understand as the cornerstone of their training.

Two Sets of Rules

So what happens if you read a few books on how to trade/invest and watch the financial media talk about investing for a significant period of time? What happens is that you would come to believe certain rules.

- Selecting the right investment (i.e., picking the right stock) is everything, and when you find the right investment, you should buy and hold it for a long time.

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- There is some Holy Grail method out there for selecting the right investment, and that might involve spending a lot of time analyzing the market to find the right investment. Warren Buffett, for example, is quoted as saying “you should know every detail of every listed stock,” as if that were the key. If it seems like a lot of work, it is. But don’t worry; that’s not the key to success in the markets.

Other rules might include:

- The market will determine whether you make money. You are at the mercy of the market in the short term, but if you hold on, you will prevail. The market eventually goes up.
- If you do lose money, it’s not your fault. Find someone to blame and a good lawyer to help you sue them.
- The market is efficient.
- Asset allocation is very important (even though most people aren’t even sure of what that really means).

My experience indicates that these rules are what cause most people to be net losers in the markets. Through my modeling work with top traders and investors—looking at what they do and how they think—I’ve come up with a new set of rules. We call these rules *Tharp Think*.

Let’s look at these rules. First, you must understand that trading profitably and consistently is not easy. Sure, you can go into a brokerage company and open an account; that part is certainly pretty easy. As the e-trade baby says, “See, I just bought stock.” And the industry wants you to think it really *is* that easy—that even a baby can do it with the right trading platform.

Can you imagine being allowed to perform open-heart surgery simply by strolling into an operating room and declaring that you want to do so? Of course not. It doesn’t work that way. Similarly, can you imagine building a bridge just by reading a book and then being put in charge of a construction team? Or, worse yet, giving a few orders to the construction team and then going along on your merry way? Again, it doesn’t work that way.

Big Money wants you to think otherwise. They want you to believe that you need only turn on some financial program and listen to the stock picks. But trading with no preparation can be as

fatal to your account as an untrained surgeon would be to a patient or a bridge built by someone with no understanding of engineering would be to anyone with plans of crossing it.

Thus, the first new rule is that trading is as much a profession as any other. It takes significant time (several years) and a deep commitment to become a successful trader. I hold a similar belief to author Malcolm Gladwell, who says that the best people in every field usually excel because they have successfully practiced their craft for well over 10,000 hours. And when it comes to trading, it's not just 10,000 hours of practice, because I've definitely seen people who have put in 10,000 and learned very little. I think that it's probably 10,000 hours of practice at doing it well.

The first new rule is that trading is as much a profession as any other.

The second new rule is that trading reflects human performance just as much as any top athletic endeavor. You must understand that you are responsible for the results you get. Thus, you should devote significant time to working on yourself in order to be successful.

The second new rule is that trading reflects human performance just as much as any top athletic endeavor. You must understand that you are responsible for the results you get.

The third new rule is that objectives are important. Furthermore, you achieve your objectives through position sizingTM strategies. The quality of your system just tells you how easy it will be to use position sizing strategies to achieve your objectives. Most people don't even think about objectives, except that they'd like to make a lot of money and avoid losing, and they don't have a clue about position sizing strategies. They learn that asset allocation is important, but they never understand that what makes it so important is the "how much" factor, which is what position sizing strategies are all about.

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The third new rule is that objectives are important. Furthermore, you achieve your objectives through position sizing strategies.

The fourth new rule is that trading/investing is all about probability and reward-to-risk ratios under specific market conditions. When you understand these rules and the market conditions at any given time, you can use statistics to predict some boundaries for your performance. While you cannot predict the future, you can get a good idea what your performance will be through statistics and proper sampling under the different possible market conditions. As you begin to understand this, you'll be amazed at the changes that occur.

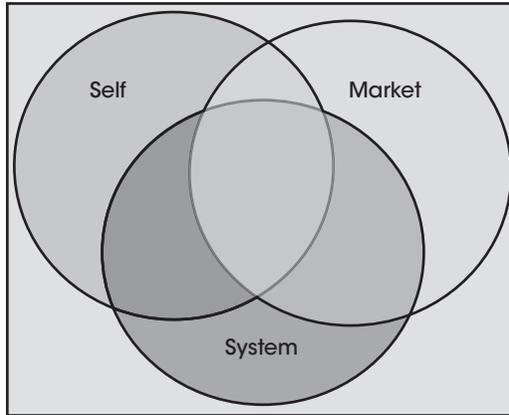
The fourth new rule is that trading/investing is all about probability and reward-to-risk ratios under specific market conditions. When you understand these rules and the market conditions, you can use statistics to predict what your performance will be under similar market conditions in the future.

The four primary rules above have many parts and other rules that are required to implement them. Together, they form what I've been calling Tharp Think. When traders join my Super Trader program, the first thing I require is that they thoroughly understand all of the Tharp Think rules. That checklist is given in Chapters 6 and 12.



How much should I risk?

What the rules seem to have in common is (1) a statistical approach to markets that (2) relies on thinking about reward-to-risk rather than being right. They also emphasize that great performance is a function of what the market gives you, your system, and you, as shown in the diagram below where the three circles intersect.



Stay Aligned

Can you see how the “old rules” that everyone seems to learn can lead to disaster, while the second set of rules is a major transformation of the trading game and can lead to success?

Section I Contents

In Section I of this book, I present three chapters written by my Super Trader candidates to show the effect of a Level I transformation on their trading.

Chapter 1 is by a new candidate who talks about his growth as a result of adopting Tharp Think and how, at one point, he was able to make 130 percent on his capital as a result of doing so. He also discovered that he was very inefficient in his trading, which is why he joined the Super Trader program in the first place. While he was up 130 percent, his mistakes probably cost him another 50 percent. In other words, without mistakes, he would have been up about 180 percent instead of 130 percent. Now he’s in the Super Trader program working on making Level II transformations.

Chapter 2 is by someone who did an amazing job of applying the Tharp Think rules. First, he figured out how important Tharp Think was. Then he found someone to help him program various systems he'd developed in an automated trading platform. Finally, he hired someone else to trade the system. Because this other person had no psychological investment in the trades and was being paid for mistake-free performance, they could trade it with nearly 100 percent efficiency.

My first Super Trader graduate wrote Chapter 3. In it, he talks about his personal journey to success. He started out as a bank loan officer who wanted to trade and, as a result of going through the Super Trader program, he found some unique ways of applying Tharp Think to alternative forms of investment, such as real estate. Within a year of joining the program, he was able to give up his well-paid job as a bank loan officer and become a full-time investor/trader. And because his passive income far exceeded his expenses, he was financially free—something he'd never been able to accomplish back when he was still “working” for a living.

In Chapter 4, one of our instructors, Ken Long, shares his journey. Ken has a master's degree in systems design and a doctorate in decision making under uncertain conditions. He's constantly developing great systems and teaches them in our courses. Ken regularly publishes the monthly performance of these systems as well as the performance of his students when he conducts live trading classes at the Van Tharp Institute.

Finally, Chapter 5 is by a former institutional broker who used to make huge six-figure salaries executing the orders of institutional traders. He knew many of the London-based institutional traders and says that there were very few who really knew what they were doing. Of course, after 20 years of watching the behavior of most traders, he thought *he* knew what *he* was doing. It took a journey into Tharp Think for him to start making the kind of progress that transformed his trading.

CHAPTER 1

I Just Made 130 Percent—and That Was Just the Beginning

David Witkin

Dave Witkin is a part-time management and information technology (IT) consultant who has been trading on and off for 15 years. His passion for trading blossomed in the mid-1990s when he read the 1994 edition of Hagstrom's *The Warren Buffett Way*. After exploring fundamental analysis, his trading interests broadened to technical analysis and options. He was primarily trading options in 2000 when the market changed course and he saw his account value drop to near zero. This wake-up call gave him a much-needed respect for risk and initiated his journey to understand the methods of the best traders in the world so that he could eventually become one of them. In 2010, he had a breakout trading year using many of the methods recommended by Dr. Tharp, and finally decided to commit to making trading a full-time career. He is currently working to complete Dr. Tharp's Super Trader program. He's finished with the psychological portion and he expects to begin trading full-time in 2013.



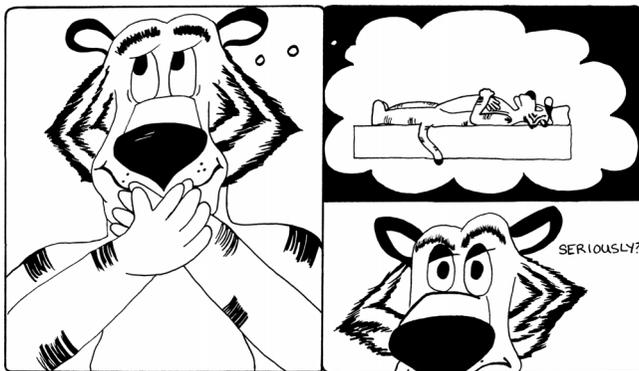
Before: Inconsistent trader with no real risk management approach other than gut feel. Most trading years were losing years.



After: Developed a well-defined position-sizing approach with controlled risk. Made 130 percent with no more than a 20 percent drawdown in the first year he applied the Tharp Think principles.

“That’s another 1R* loser,” Van announced to the class as he drew the final marble from the bag. There was an audible groan from most students—but not from me. “Okay,” I thought, “maintain your composure. No matter what, *do not* smile. Smiling would be bad. Just think about dead cats or something.”

The 25 or so guys in the class were just like me—reasonably smart, decent people trying to transform themselves into world-class traders, and each was sacrificing the Saturday before Super Bowl Sunday as proof of dedication to the craft. I certainly didn’t want to alienate any of them, but Van’s announcement meant I’d just won the pot in a game designed to illustrate a critical trading concept. The pot was small, but the win proved I had made a major change in how I thought about trading. To me, the win meant that, in a class of smart, driven traders and in front of one of the top trading coaches in the world, I was the top dog that day.



“No matter what, *do not* smile. Just think about dead cats or something.”

It was February 2011 and I was attending a “Tharp Think” seminar in Cary, North Carolina, a small town just outside of Raleigh. For me, the seminar was an opportunity to celebrate the end of my

*It means that you have lost what you risked. 1R means one unit of risk.

best trading year ever—over a 130 percent gain—and to reinforce the concepts most responsible for getting me there.

Learning to Trade

My path to trading was anything but direct. After working briefly in information technology (IT) after high school, I went to college and received a liberal arts degree. When I graduated, I worked a couple of IT jobs until I found a home as an IT and management consultant at a Big Five accounting and consulting firm.

By this time it was 1998, and I had become fascinated with making money in the markets. It seemed incredible to me that millions of people could come together to find the “right” price for a company, and the people who were great at it could become as rich as Warren Buffett. The company I worked for gave me the opportunity to spend seven months in Germany. That was a great opportunity to lock myself in my small apartment and read everything on trading I could get my hands on, and maybe do a bit of trading myself.

Germany was a perfect place for me to focus on learning to trade. I didn’t speak the language and didn’t know anyone except the people I worked with, so I read in my spare time. First, I focused on fundamental analysis, reading books about how people like Warren Buffett, William O’Neil, James O’Shaughnessy, and David Dreman invested and identified companies worth buying. Next, I learned about technical analysis from Martin Pring, Stan Weinstein, and Trader Vic. Then I found options, reading the whole 800-page *Options as a Strategic Investment*, by Lawrence McMillan, as well as books by George Fontanills and others. I became fascinated with limited risk and the incredible complexity of trades I could create using options. *Wow, I thought, these things are amazing. There is an option strategy for every possible situation, and look at the leverage! Woo-hoo!*

I liked saving money and had managed to put away \$20,000, so I started trading. Sometimes I’d do some fundamental screening and then decide to buy a few stocks. Other times I’d find momentum stocks and buy options that were expiring in a few months. I also subscribed to some newsletters and would pick and choose investments that sounded good to me, primarily looking for those I thought had the best chance of a significant return. In hindsight,

I really didn't have much of a trading strategy. There were no real entry criteria other than the caveman approach: me see, me like, me buy. There was no predefined exit point where I'd admit I was wrong and get out, and I decided how much money to allocate to each position by gut feeling.

Unfortunately, I lost on more trades than I won, which confused me. After all, I'd done my homework and learned tons about how great traders won in the market. I had good reasons for entering every trade. *I should be winning much more money*, I thought. When I talked to people at work, it sounded like *they* were making money—a lot of it. But why? I knew I'd studied more than they had. When I talked to them, they didn't know anything about the fundamentals, or Warren Buffett, or technical analysis, or cool option terms like “delta,” “theta,” and “gamma.” I understood *gamma*, for heaven's sake! How cool was that? I thought I was destined to make money.

Even though I lacked a trading system, the markets were excellent, and even though I was losing more money than I thought I should, I was still making money. By 2000, I'd managed to build my starting capital into about \$75,000 by saving a bit more from my day job and benefiting from what, in hindsight, was a fantastic market. My family never had much money—my clothes always seemed bargain-basement compared to my friends and the highlight of many family “vacations” consisted of visiting relatives—so \$75,000 seemed like a small fortune to someone like me who was still in his twenties. I still felt I should be making more though, so I continued to read and learn, but, overall, I was proud of the little pile of money I'd made. I'd done it on my own, after all, which made it even more meaningful.

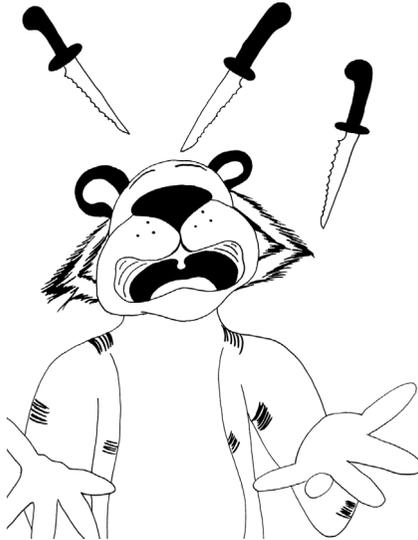
“Danger, Will Robinson, Danger!”

In late 2000, I read something on the Internet suggesting that to win in trading you needed to have the right psychology. This was an angle I hadn't thought of—you needed the right psychology to be a good trader? Could this be true? I was skeptical. The guys at the office didn't seem to give a hoot about psychology, and they were making money. I made money, and I was sure my psychology wasn't special. Even so, I decided I would explore it before ruling it out.

My introduction to trading psychology would come in the form of a book called *Trade Your Way to Financial Freedom* by Dr. Van K. Tharp. I didn't know it at the time, but the date I ordered Dr. Tharp's book, in 2000, was within weeks of the end of one of the longest, most profitable bull markets in U.S. history. I was 30 years old and about to lose most of my net worth. I put the book on a shelf rather than read it so I could continue to focus on making money.

When the bear market began, I continued trading as I had the prior few years—I didn't follow any real strategy, but I'd read a ton and thought I understood enough to make money. I traded some on the short side, but my primary focus was long. The market had been going up for most of the last 20 years and the downturn in late 2000 seemed like just the buying opportunity I'd read about, with "blood in the streets." Some great stocks were now real bargains: Worldcom! Global Crossing! Earthlink! Puma Technologies! I bought them all.

I soon discovered the importance of applying the appropriate metaphor to the current market situation. Yes, there was "blood in the streets," but the proper metaphor for the moment was



Don't try to catch a falling knife!

12 Trading Beyond the Matrix

something like “don’t try to catch a falling knife” or “low stocks can always go lower” or “don’t fight the tape.” Funny thing about trading metaphors: most of the “market experts” who quote them don’t give you any truly helpful advice on when to apply one versus another. The metaphors always sound wise when someone says them, though, don’t they?

Over the next two years, the S&P 500 plunged more than 40 percent and, in a show of solidarity, the vast majority of my money went down the drain with it. I was angry and disgusted with my failure and determined not to lose all my marbles again.

But how should I move forward? Clearly eeded to change what I was doing, but what was the best way to do that? I thought I’d already read the right books, so what experts could I trust to help me? Was there a different way of doing things—a different trading metaphor—I should be using? My trust in the traditional “experts” had diminished in lockstep with my account value. Maybe that book by Dr. Tharp was worth a read now.

Tharp Think 101

I love to learn. Any time an author can add some knowledge to my repertoire, I’m always excited. Consequently, I devoured *Trade Your Way to Financial Freedom*, a book that seemed to be about more than just psychology. The psychological parts struck me (at the time) as being a little too intangible to be relevant to trading. I wanted to make money, after all, and still wasn’t convinced that psychology was the key to making money in the markets.

Dr. Tharp clearly understood how I thought about trading, and as a result, the book grabbed me immediately. I read about “Holy Grail” systems, as Dr. Tharp refers to them—“perfect” systems that focus on picking the right stocks* and on when to enter the market, and that work whether the market is bullish, bearish, or neutral—and realized that I’d been spending my time looking for one myself. I didn’t want to think about having different systems to enter the market—one when the market was bullish, one when the market was neutral, and one when the market was bearish. What a pain that would be! Wouldn’t it just be easier to use one system for

*This is actually other people’s definition. My definition of a Holy Grail system is one that produces an SQN score over 7 for a particular market type.

all markets rather than a different one for each type? Not only that, but also having one system per market type would mean I'd need a way to determine the market type. In other words, this approach would require me to do more work.

Unfortunately, Dr. Tharp said that expecting a system to work in all types of markets was insanity. *Ugh*, I thought, *implementing this guy's ideas is going to take time and effort*. My brain was already trying to find a way out of putting in the work his suggestions required. In hindsight, I see that I had no concept of the amount of work required to implement all his ideas. *Double-ugh*.

He also said that making a lot of money in the markets would not be fast or easy. *I don't like this guy*, I thought. Although many of his ideas made sense, I really didn't want anyone telling me how hard trading would be. After all, I'd read tons of books and done more work than most people. The work should be hard for *them*, those people who hadn't done as much work as I had, but not for me. I wasn't done with the first chapter yet, and this guy was already frustrating me. Just give me the bullet-point list of how to make money!

Still, I kept reading, and Dr. Tharp kept pressing my psychological buttons. He said there was very little chance anyone could give me a system I could use to make a lot of money in the market. He didn't say the system couldn't be built, only that if someone gave it to me it probably wouldn't work for me. I started thinking Dr. Tharp was off his rocker. He seemed to be saying that if someone gave me a perfectly good system I'd screw it up somehow. How could he make such a broad statement? I'm smart, disciplined, and successful in my nontrading career, so he must have been talking about other people, not me (it would take me nearly a decade to realize he was right, and my inability to find a system that consistently worked well for me was a direct result of continuing to look to others for the *perfect* system).

So, why did I keep reading? I guess because many of the ideas did resonate with me. For example, Dr. Tharp said that winning traders often lose on more trades than they win—maybe winning only 35 percent of the time. Making money while winning less than 50 percent of my trades was exactly what I experienced in the late 1990s, and Dr. Tharp clearly understood the phenomenon. He discussed having a positive expectancy, or mathematical expectation of profits, and provided a simple formula to calculate it. Because

losing is a part of the game, he discussed the importance of learning how to accept losses as part of trading and not making them worse by failing to admit when you are wrong on a trade. All of these ideas resonated with me.

Dr. Tharp also talked about the importance of taking responsibility for your results. In other words, if you decide to trade based on newsletter recommendations, as I did, and lose money, it is your fault, not the newsletter's fault. You chose the newsletter, and you chose to invest based on its recommendations. You decided to trust the newsletter's published results, showing they won 75 percent of the time. You decided not to paper-trade the recommendations for six months to confirm the results before starting to trade real money. You didn't stop to find at least one independent source who had confirmed the newsletter's track record before trading. You, you, you!

While it was frustrating to take full responsibility for my losses, I knew it was the right way to view the situation. Have you ever blamed someone else for your poor trading results? If so, go ahead and try the taking responsibility exercise above with any external sources you counted on for trading advice, and see if you can figure out how you might have caused the disaster you blamed on them. Your broker told you to buy that stock, and you trusted him? It was your choice. Your money manager vanished with \$1 million, your entire net worth? You didn't do enough background checks on him because you didn't consider the possibility that he might steal your money. You also chose not to split your money into three equal parts and give each part to a different money manager. Try the *it wasn't my fault* game yourself next time you lose money. If you can't trace the results back to you, ask other people to help you, and tell them to be relentless.

Yes, it is, of course, true that many events are unlikely and that none of us has the time to explore every option for every decision. If we did, nothing would get done. But what about the big decisions, like where to invest your entire net worth, or whether to start trading with real money with a system you haven't paper traded? Aren't these decisions big enough to warrant some contingency planning?

When you stop and really think about it, how could I fix something if I didn't think that allowing it to happen was my responsibility? Is it possible I didn't do all the checking I should have on

that newsletter because I didn't know whom to talk to? Or maybe I didn't independently validate the results because I didn't know how and didn't think about paying some college kid \$500 to do it for me because that would be too expensive? Maybe I didn't want to wait to make money and thought about all the money I *wouldn't* be making if I paper-traded the system for six months?

Chances are you're at least somewhat like me and avoided (yes, avoided!) taking a few prudent actions that could have saved you a pile of money. Test yourself; if you aren't able to come up with 5 to 10 things you could have done differently, you're not trying hard enough. More importantly, you're likely to continue struggling with trading in the future.

As I continued reading, the book talked about a number of psychological biases that cause most people to do exactly the wrong things in the market. For example, we don't have the mental capacity to take in all the information the market makes available, so we generalize, delete, or distort the information. Consequently, if you believe that trend-following systems don't work, you probably feel content to ignore information about how to trade them. *Ala-kazam!* You've just seen a judgmental bias in action. You generalized (trend-following systems don't work), and as a result you were able to massively cut down the amount of trading-related information you have to pay attention to. But was your generalization correct?

Another bias is the so-called lotto bias, which describes the confidence people develop about their chances of success when they have some control over the information necessary to win. For example, many traders become irrationally confident they will win because they are using a group of indicators—moving averages and oscillators, for example—to tell them when to enter the market. Other people, like me, feel the same irrational sense of control and chances for success because they get to choose which of the newsletter's recommendations to buy. Ugh.

As I read on about the other biases and how they affect traders, I was hooked. Dr. Tharp gave compelling examples, and I could see my own actions in many of the behaviors he discussed. The book said that most people think of a trading system as the answer to the question: When do I enter the trade? At the time, I couldn't have agreed more; I was totally focused on market entry. Unfortunately, when to enter is the least important part of a trading system. I've heard Dr. Tharp and Linda Raschke, another market wizard, say

they have tested random-entry trading systems that make money, albeit not enough to be easily tradable. These systems enter the market on a coin toss and use good exits to accept losses and take profits, and they seem to confirm the relative importance traders should ascribe to exits, not entries.

Even with all of the things that resonated with me, though, there were plenty of things that didn't, at least not immediately. For example, Dr. Tharp argued that a good trading system would have 10 parts, the most important of which is objectives. Objectives? Seriously? I want to make as much money as humanly possible, that's my objective! Anything less would limit my potential, wouldn't it? What crazy person would want to limit how much money he could make in any year? Unfortunately for my ego, I discovered as I continued reading that the book made a good case for determining your objectives before designing or trading a system. *Darn, I thought. This Tharp guy is really starting to annoy me.*

Not All Lessons Are Equal

I found a number of the book's concepts provocative, but by far the most potent for me was the power of position sizing strategies. A position sizing strategy is simply the part of the trading system that answers the question, "How much will I risk on this trade?" Sounds simple, doesn't it? It is, and it isn't.

What if I told you I would put you into a fully automated trading system with the following characteristics: It wins 35 percent of its trades, and when it wins, the winning trades are, on average, three times the size of the losers? What if I also told you I had been trading the system for 25 people, each in a separate account, for the past 10 years? While some years were better than others and the system was in negative territory for at least a portion of every year, all of the last 10 years were profitable for *every* account. All of the accounts were with the same broker, started with \$100,000 and had exactly the same commission structure, and the system only traded liquid markets. Sound interesting?

Here's the twist: While the system made money every year, the percent-gain realized was very different for each of the 25 accounts. The gains ranged from 4 to 95 percent gain last year and from 2 to 72 percent the prior year. The previous eight years showed similarly

diverse performance across accounts. The performance was independently validated by a credible accounting firm and found to be completely accurate.

But how could this be? Remember, this is a fully automated system—the trades were entered and exited automatically, everyone started with the same equity, took exactly the same trades, and exited at the same time. Small differences in percentage gains across accounts could be accounted for based on slippage, but slippage couldn't come close to causing this range of differences. What was going on here, you ask?

The answer is *position sizing strategies*. Each trade was exactly the same for each account—with the exception of *how much* money was risked on each trade. The owner of account one risked 0.5 percent of account equity per trade, had the smallest drawdowns and the smallest gains every year; the account owner's objective was to minimize drawdowns. The owner of account 25 used a more complex position sizing strategy, which risked more and more money as the account equity moved further into positive territory. Account 25 also experienced significant drawdowns, the largest being 65 percent. This account owner's objective was to make at least 50 percent per year, even if it meant a maximum drawdown of up to 75 percent. And because he was willing to suffer the drawdowns, most years he made at least 50 percent.

These sample accounts show just two possible methods of using position sizing strategies¹ to achieve objectives. There are a number of other position sizing methodologies that could be combined to build thousands of strategies. For example, most traders recognize the importance of volatility in markets, and, while not universally the case, many traders feel that more volatility equals more risk. So what if you took smaller position sizes when the market displayed significantly higher-than-normal volatility (e.g., double the average true range measured over the past 90 days)? Or what if you combined position sizing strategies by risking 1 percent of account equity except when the volatility goes above some predetermined threshold? Each of thousands of position sizing possibilities could result in a different ending equity level despite taking *exactly* the same trades.

The variability in results sounds too incredible to be true, you say? I'm right there with you—or at least I was until I did some independent research, which seemed to support the case that

position sizing was capable of making this kind of difference in returns. I also used some software to test the impact of position sizing strategies on my own, which cemented the case for me.

But don't take my word for it—there's an easy way for you to test it yourself, and it won't cost you more than \$20. Remember the marble game I mentioned at the start of this chapter? The marble game is nothing more than an example of using position sizing to achieve your objectives (e.g., one objective being to win the game at all costs, even if it means going bankrupt). Here is how you play:

- Put the 100 marbles described in the last bullet below in a black bag.
- A person randomly pulls out one marble each turn, and the game ends after 60 marble pulls.
- All players (why not invite the family to play? Trust me, it's fun!) start with \$100,000 and choose the amount to bet *before* each marble pull.
- The minimum bet is 0.5 percent ($\frac{1}{2}$ of 1 percent), and the maximum bet is 100 percent of your equity as it stands prior to each marble pull.
- After each marble pull, the result is recorded (i.e., the marble chosen), and the marble is returned to the bag.
- There are different colored marbles in the bag, each with a distinct outcome:
 - ◆ 65 black marbles, where you lose whatever you bet
 - ◆ 15 blue marbles, where you win whatever you bet
 - ◆ 7 green marbles, where you win $2 \times$ your bet
 - ◆ 6 yellow marbles, where you win $3 \times$ your bet
 - ◆ 3 silver marbles, where you win $5 \times$ your bet
 - ◆ 2 gold marbles, where you win $10 \times$ your bet
 - ◆ 2 pink marbles, where you win $20 \times$ your bet*

*If you do the math, this system produces 65R in losing trades and 122R in winning trades. However, there are 65 losing marbles and only 35 winning marbles. Thus, you have a 65 percent chance of losing on a given draw compared with a 35 percent chance of winning. But if you add up all the wins and losses, it totals $(122R - 65R = 57R) + 57R$. Expectancy is the average R-value, which in this case is $57R/100$, or 0.57R. Thus, on average, you'll make 0.57R per trade in this system.

Remember—the point of the game is to help you understand the importance of position sizing strategies. Every player gets exactly the same trades (i.e., marbles); the only difference is the size of each bet. That being said, the marble distribution above is actually similar to the trade distribution of many good trend-following systems (i.e., you lose 65 percent of the time, but, if you use an appropriate position sizing strategy, the size of your winners makes the system very profitable).

Yes, Dr. Tharp's book was an eye-opener for me, so you might think I started using what I learned from the book to my advantage right away, and to some degree I did. Over the following years, I continued to trade lightly, still somewhat shell-shocked from my earlier losses. I continued to learn and test systems, but never to the point where I was comfortable enough to trade them with real money. I kept reading books by Dr. Tharp and began accepting some concepts I rejected earlier, like the importance of objectives. I continued to take some newsletter trades; some won, some lost. On balance, I probably broke even. Regardless, my trades were too small to make a significant impact on my bottom line.

Too small, that is, until 2004. Late that year I decided I would be comfortable risking some money on a “proven” mechanical system. I searched the Internet and found a system designer who sold me two complementary black-box systems—that is, systems whose underlying logic is hidden, so that you can only see the trades it spits out—for about \$3,000. The back-tested results were excellent. Collectively, with a position size of 1.5 percent of equity on each trade, the two systems returned better than 50 percent per year with a worst-case drawdown under 35 percent over a 25-year period, and the results were reasonably consistent across years. I removed myself completely from the trading equation by finding a Commodity Trading Advisor (CTA) to trade the systems on my behalf and waited for the money to roll in.

About two years later, I closed the account after losing 50 percent of my money. Ugh. Again, I thought I'd made good decisions, carefully researching the systems before buying them, and allowing someone else to trade them mechanically on my behalf. Unfortunately, it appears the system designer curve-fitted the results. Curve-fitting means you optimize the system on historical data until you get results that look fantastic. The problem with curve-fitted systems is that they tend not to do so well in the future. This was

another lesson learned the hard way: if you don't know how the system was tested, there is a good chance it wasn't confirmed effectively and the results aren't worth the paper they're printed on.

For the next few years, I did very little trading, choosing instead to watch the markets and continue reading and learning on my own again.

Finally, Some Winning Marbles

In early 2010—almost 10 years after buying *Trade Your Way to Financial Freedom*—I thought I might be ready to try trading again on my own. I was still scared of losing, but believed that if I kept my position sizes relatively small, I could stop trading and limit my losses. To promote discipline, I created a few simple rules for myself:

1. Never risk more than two percent of total account equity on any trade.
2. Always enter a stop-loss order along with an entry order (my broker allowed both to be entered at the same time as linked orders—very helpful).
3. Reduce my position size or just get out if I start to feel uncomfortable.
4. Use trailing stops to exit the market.
5. Focus on trading two low-risk ideas: (a) channel breakouts and (b) bounces off support.
6. Enter trades only when I believe there is a good risk-reward ratio of at least three to one.
7. Get out of the market completely for at least two weeks if I experience an account equity drawdown of 35 percent.
8. If a position is going against me or taking too long to move in the direction I thought it would move, exit before the trade hits the stop loss if I no longer feel good about it.²

This set of rules was not even close to what Van would consider a comprehensive trading plan, but it helped me do enough things right to capitalize on some big, very profitable trends.

I waited until May to take my first trade of the year, a natural gas bounce-off-support trade. The trend was strong, and I added to my position as natural gas moved up, while locking in profit by moving up my stops as the trade went in my favor. The trade ended up being a 5R winner—in other words, I made about five times

what I risked on the trade. If I'd lost on this trade, I'm not sure I would have been confident enough to keep trading, which is very significant when you consider my results for the year.

While I still lost more trades than I won—I think I only won about 30 percent of my trades—the winners were big, and I did well. As of December 31, my account value was up more than 130 percent, and I never experienced a drawdown greater than 20 percent. I was excited—so much so that I took screen shots of my account equity each time I reached a new equity high, almost as if I needed visual evidence that my results were real. As much as I wanted to have a year where I made 100 percent+, I wasn't sure I could really do it.

Despite the success, I made tons of mistakes that cost me some very significant money. My guess is that I probably would have made at least 180 percent, probably more, without the errors. For example, in December, my wife gave birth to our first child, and I didn't follow my positions as closely as I should have while I was with her in the hospital. I had my stops in place, but I wasn't able to exit on intuition as I did at other times when I saw the market wasn't moving quickly in my direction.

Also, I held too many positions—sometimes as many as 15 at once—and it turned out that some of them were correlated. After experiencing a drawdown as a result of correlations, I subscribed to a correlation service. The service provided a matrix of correlations, and I was more careful only to take positions with little to no correlation over the most recent 1-, 5- and 10-year periods. Unfortunately, I learned the hard way that correlations on any given day don't really care about historical correlations over 1-, 5-, and 10-year periods—another lesson with a high price tag. Big ouch!

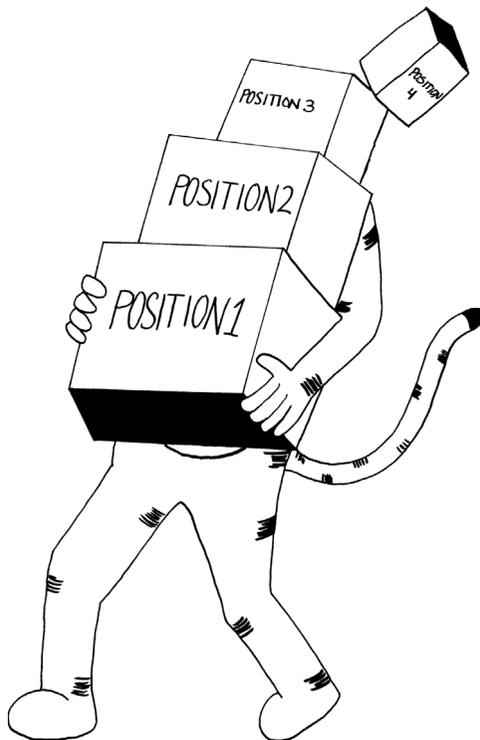
Also, as I continued to trade, I noticed that my criteria for taking trades became more lax. Sure, I still looked for breakouts and bounces off support, but I seemed to get less picky about only taking the trades that looked the strongest. I became more impulsive. I found I really wanted to be in trades because I was afraid I might miss a big move if I wasn't in the market, and missing a big move would be painful. As a result, I had far more losing trades later in the year and forfeited profits as a result.

I also wasn't very methodical about keeping a trading log and reviewing it to find and address my mistakes. I looked over my trades and noted some of my mistakes, but I didn't set aside the

time I needed to do a good job of it. If I had, I have little doubt I would have avoided at least some losses.

I also risked way too much per position early in the year. After a couple of months risking about 2 percent of account equity per trade, the account fluctuations told me I was risking too much. I cut back to 1.5 percent and later to 1.25 percent. These reduced-risk levels still allowed me to have significant gains, but, more importantly, they reduced my daily account fluctuations and improved my peace of mind. I find it funny now, but before 2010, I remember thinking, “How will I ever make any real money if I only risk 2 percent of equity per trade?” If this statement rings true to you, play the marble game risking 2 percent of equity per trade, and then do it again risking 10 percent of equity per trade, and prepare to be enlightened.³

I firmly believe that looking for good reward-to-risk trades and using a reasonable position sizing method were the most important



I held too many positions.

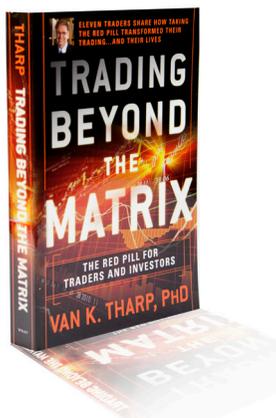
factors in my results. The scientist in me is the first to admit that there was some luck involved on individual trades—but it would be hard to make the case that luck was a major factor on the 100+ trades I made over seven months. Even with all of my mistakes, I used enough of Dr. Tharp’s principles to knock the cover off the ball.

So, what now? I’ve stopped trading and am going to take some time—at least a year—to focus on becoming a more efficient trader. As Dr. Tharp defines the term, *efficiency* means reducing the number of mistakes you make to the point where they have little impact on your results.

I’ve mentioned a number of things I plan on improving, but I haven’t talked about my psychology. You may recall my views about the value of “trading psychology”; at the start, I was doubtful that psychology was important, let alone a key to trading success. Dr. Tharp wrote about the importance of a trader’s psychology in *Trade Your Way to Financial Freedom* and other books, but it didn’t completely resonate with me. After all, why would psychology matter if I had a good plan and stuck to it? Wouldn’t that take psychology out of play?

It took about 10 years, but I’ve come to realize the answer is probably “no.” Psychology was the reason I made those mistakes in 2010. Psychology is the reason I haven’t invested more time in pursuing my dream of becoming a full-time trader; I was scared of walking away from a lucrative day job and of what my family would think. And psychology was responsible for the mental chatter, uncertainty, and discomfort I felt as I traded, and I’m sure it cost me in terms of returns. So, as with other Tharp Think concepts I initially resisted, I’ve come to believe that psychology is a big factor in becoming a consistently successful trader, and I’m planning on spending the next few years getting mine where it needs to be.

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