Van K. Tharp, Ph.D.

Market Mastery

Putting Peak Performance to Work for You

Who is To Blame for Today's Economy?

By

Van K. Tharp, Ph.D.

I am doing a lot of talking with the media these days and one of the primary things they are looking for is someone to take a stand either for the Republican or the Democrats via today's economy.

So let's see how I'd answer the kinds of questions that are posed.

What can we expect from today's economy? Is the news good or bad?

We're in a secular bear market that started in early 2000. We had a one year correction up in 2003 and now we're due to get the second down phase. Steve Sjuggerud's 1-2-3 model turned to red light mode as soon as the Federal Reserve raised the discount rate by a 1/4th percent. In fact, a few weeks later the model turned to super red light mode, when the S&P 500 dropped below the 45 week moving average. That's only happened three times before in the last 30 years. According to Sjuggerud, it occurred right before the 1987 crash; right as the new secular bear got started in 2000; and in 1994. In 1994 the

Continued on page eight

A Conversation with Van K. Tharp

By

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Part I *Continued*: What Builds Consistency Into Your Trading Performance

Part II: Doing Great Research to Develop A Great System

This month's interview is a continuation of a position statement in which I'd like to share a number of new ideas and developments with you. These include:

Part I: Factors That Build Consistency Into Your Trading Performance.

Part II: Factors Involved In System Testing and Development.

Part III: The You Factor: Consciousness, Discipline, and Inner Work.

Part IV: Financial Freedom and the SafePaths branch of the Van Tharp Institute.

This series started in July, and I suspect that it will take several issues of Market Mastery to completely cover all of them. Many of these questions were generated by you, but some were self-generated just to convey a point I wanted to make.

We have been talking about the factors that you need to include in your trading business plan to help build consistency into your trading. The last one had to do with building discipline in your system and I think we covered that pretty well in the last issue. Okay, so let's talk about what you should say about your budget and cash flow systems?

Every business has many systems. By system I mean something that is automatic that really helps people know what to do when running a business. For example, a fast food restaurant will have systems to help you greet customers and serve them within a minute. They will also have systems for preparing food, for cleaning up, for managing cash flow, for dealing

Continued on page two

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with problems that arise, etc. And your business of trading needs such systems too.

The most important of those systems has to do with your cash flow and budgeting.

What is it going to cost you to run your business? What does equipment cost you every month? What does Internet connectivity cost every month? What do you pay for data? What do you pay for education? How about subscriptions? What else is part of your regular monthly outflow… how about research time or perhaps just your salary?

All of this should give you an idea of what revenue you need to make every month to have a profitable business. What is your hourly wage as a trader? Are you making below minimum wage? What is your salary? This should be answered (or at least well planned) in a very detailed manner in your business plan.

Since you mention it, what other systems might you need?

It somewhat depends upon whether you are managing your own trading business or trading for others. Let's say you are trading for others because that's more complicated.

What would you need to consider?

You will need to get customers – thus, you'll need some sort of marketing of your business. How will you legally let people know about what you can do for them. That should be a complete plan or at least a section of your business plan.

Next, you will need to know how to keep your customers happy. How will you deal with customers who call you on a regular basis with questions about your trading? That can be a real distraction. What will you do on a regular basis to minimize the need for your customers to call you? For example, you might want to have a newsletter going out to them weekly or monthly. How will you report results to them? How will you manage things when your results are poor? And just as importantly, how will you manage things when you do well and your customers get excited and want that performance to continue. These questions should all be answered as part of your planning.

Next is your back office. How will you keep track of your customers? How will you send statements to them? How will you keep track of your performance – especially if you have a lot of individual accounts you are managing? How will you do bookkeeping? How will you manage your data? What if you have errors in your data? What if you have errors in your trade fulfillment? These are just a few of the questions you'll need to answer with respect to your back office? You'll need to plan for this.

What if you are not trading other people's money?

You'll still have some of this to deal with. If you are married, you'll probably have to deal with your spouse – who might be considered a customer. Thus, you'll have some customer management issues you have to deal with from him/her – especially if the trading doesn't go well.

You'll certainly have data problems and problems dealing with order fulfillment and keeping track of your trades and accounting problems. Thus, even if you are trading your own money, you should plan for these things in your trading business plan.

You also have a section in there on worst case contingency planning. That's really planning for negative things to happen. When you think about the negative, doesn't that produce it?

That's a great question. The idea behind a worst case contingency plan isn't to put negative information into your head. If fact, when you brain storm to think of what could happen, approach it as a creative exercise. If you do it from that perspective, there is really nothing negative about it.

The purpose behind it is to prepare yourself for what could go wrong. The market will usually find something that you are not prepared for and give you a great test of your fortitude. When this happens, and you are not prepared, you become stressed and your brain shuts down. Typically, you respond in a very primitive way, but with a lot of energy. For example, you might scream loudly. However, this does you very little good and some responses might hurt your account.

Do you have an example?

One of my clients day traded the S&P 500 and usually made money. However, one day his girlfriend was hurt in an accident. As soon as my client heard about it he rushed to the hospital. Towards the end of the day, when he knew she would be okay, he suddenly realized that he had open positions in the market. But at that point it was too late. Those positions had all gone against him. And in one day, he'd lost about a year's worth of profits.

That's what happens when you become stressed. You lose your capacity to think. Consequently, the first thing I had him do was develop a worst case contingency plan. And one of his new rules was: whenever a personal emergency occurs, immediately sell all positions and then take care of the emergency.

So what kind of things should you plan for?

First, brainstorm everything that could go wrong. You might find that such problems fall into five broad categories. The first category would be personal emergencies such as the example I just gave.

The second category would be disasters with the market that are not expected. Examples of that nature might include the 1987 crash – no one expected the S&P 500 to move 20% in one day, but it did. It might also include events like 9/11 when the stock market closed down for a substantial period of time. We actually had a training for our old super trader program that was like playing war games. It was developed by someone who used to design games for one of the U.S. intelligence agencies. In that training, we had a scenario in which the World Trade Center was blown up. The reaction was: "This is so unrealistic, nothing like this would ever happen." But it did – and within about five years.

The third category should include equipment and data problems. What if something happens to your computer? What if something happens with your software – especially if you don't know its happening? What if something happens to your data? What if you get faulty data and false signals? What if something happens to your phone or your Internet service? You need backups for all of these sorts of things.

The fourth category might be major things that would cause a major problem in trading if you are not well prepared. These events include: 1) having a baby; 2) going through a divorce or a major breakup with a loved one; 3) moving your office or your home; 4) a personal or family illness; 5) a personal or family death; and 6) anything else that might be a major distracter such as a lawsuit. These tend to occur over a long period of time and you need to plan how you'll respond to them. Sure, you can just stop trading. But perhaps there is also another way if you work it out and practice it.

The fifth category for this section would be various types of psychological problems that come up. This really fits under discipline, but here is where you plan for it and make sure it doesn't wipe you out.

The last category has to do with your broker. What kind of performance should you expect from your broker. What will you do with errors? Bad fills? A broker who questions your judgment? All of these are items you should consider.

That's really helpful. Should I just list out these categories?

First make a list of everything that occurs to you in each of these categories, plus miscellaneous – anything else. Plan on having at least 100 items or your list is probably too short.

Second, once you've generated your list. Now come up with three ways to deal with each situation. So if you have 100 items on your list, you need 300 solutions.

Third, now determine which solution is the most effective one for each problem and rehearse it thoroughly until it is second nature to you. This is the real value of worst case contingency planning. The more you can rehearse globally, the less you'll have to deal with it in a daily mental rehearsal.

Most people prefer to ignore this section of their plan, but it really is the most important.

And sometimes good things can be a disaster. In my company business plan, I once considered that one of the worst things that could happen would be a large order that might take me several months to fill because I didn't have enough stock. People often don't think about how "good news" could be a disaster.

Okay, and the last part of your plan is to have three-four systems ready to go?

It's probably good to have at least two good, non-correlated systems that fit the current big picture. If they are non-correlated, then you'll probably continue to make money.

For example, in *Safe Strategies for Financial Freedom*, two non-correlated systems that would work when the market is in red light mode are the bear market mutual fund strategy and the Graham's number strategy. Remember that I don't recommend that you put more than 50% of your funds into the bear market strategy. With the other 50% of your funds, I recommend you look for Graham's number stocks – stocks selling below their liquidation value. When the market's going down, you probably won't make much from your undervalued stocks, but your mutual fund should do well. And when the market rallies, you'll start to make money in your undervalued stocks. Thus, both strategies work well together. In fact, you won't get many undervalued stocks until the market is way down anyway and ready for a rally.

What else can you say about those systems?

You need to thoroughly understand each system. The more you understand about it, the less you need to test it. However, recently I've been getting a lot of comments on the bear market system about the entry. The point of the system was to get you into a bear market mutual fund and keep you there while we were in red light mode. It has some protection should the market whipsaw, and more protection should the market get way undervalued. However, generally it is designed to get you into a bear market mutual fund when the market goes down and keep you there.

Now let's look at the setups. First, we need red light mode. Second, I'd like to see all three major averages going down. And third, I'd like to see the market lower than it was five weeks ago. When those conditions are met, it's time to enter the market.

I then suggested that people enter when the market falls 2.5% on the week. And that if it falls less than 2.5% on the week, that they enter in the middle of the week when it does. However, recently we've had all the setups, but only small weekly falls in the market – 1%, 1.3%, and then 1.1%. People couldn't see why I was suggesting that they get in at all. What I would hear is that it didn't meet the entry criteria.

But remember, all the conditions were really already met, you just need an excuse to get into the market. And when the market is down for three consecutive weeks, even if the largest decline is only half of our criteria, isn't that enough to get you in. Yes, it is if you understand the philosophy behind the system. But if you don't then you'll argue over details.

What else is important?

If the system is shorter term and in and out a lot more, then you need to understand all of the intricacies of the system. I'd recommend that you collect about 50 to 100 R multiples from the system and then get a report out of Know Your System on what to expect from the system.

This report will let you apply the proper position sizing. And it will also let you know what to expect on the worst case from your system so you can prepare yourself.

And how about position sizing and risk control?

These are the most important aspects of your system. If the system doesn't work, then you should know when to get out to protect your capital. And you should always limit your exposure to make sure you don't lose too much of your capital. These are really fundamental rules of trading well.

And on the other side of the coin, you should know how to step on the gas with position sizing should the position go in your favor, by using certain types of scale-in position sizing. Thus, you are cutting your losses and letting your profits run through keeping (and adding to) a winning position.

You also recommended at least three systems – why do you need more?

What if the big picture changes? What if you are wrong about the big picture? For example, right now we're in super red light mode in the stock market and we expect a major decline. What if that doesn't happen? First, the mutual fund strategy won't make any money. It will lose money. Second, the Graham's number strategy won't make money because you won't find any stocks to buy. Thus, you need backup strategies in case the big picture changes.

What are some possibilities?

If the market starts to go up, you could buy efficient stocks. If we start to get inflation, we would probably do very well in commodities. If we start to get a declining dollar, then the max yield strategy would do well. Steve Sjuggerud seems to do well with his recommendations no matter what the market is doing, so you could even trade his newsletter recommendations. Anyway, you need backup strategies so that you always have something that will make you money.

Certain commodities, such as oil, are in nice trends so you could have a Futures system. There are many, many possibilities.

Okay, now it all begins to make sense. And I can see the value of having a business plan to guide me in this.

Great.

Part II: Doing Research to Develop A Great System

The next major issue that comes up for most people is how do you do trading research. How can you develop a great system? Over the years, we've gathered a lot of information on this particular topic. And I'd like to introduce you to that in part II of this interview.

Okay, so how do you do trading system research? How do you find a system that works?

First, I've written a book about this topic. It's called *Trade Your Way to Financial Freedom*. In addition, we also do a workshop on this topic – it's called the *How To Develop a Winning Trading System That Fits You* Workshop. I can't very well put down all of that material here. However, I have developed a number of keys steps that are involved and some of those reflect a few changes in my thinking. So here are some steps that you should consider.

Step one is that you really need to know yourself. The reason is because you can only trade a system that fits you. So how much time do you have? What can you do and what can't you do? What are your psychological weaknesses and strengths? You've got to build a system around who you are. And to do that you have to know yourself.

This relates to the prior section on knowing your beliefs and on knowing your strengths and weaknesses.

Exactly. That's why I recommend you write out all of your beliefs about the market and examine them thoroughly before doing this step. And if you don't have any beliefs about the market, then I'd recommend that you read some of the old market classics. These books would include:

- All of Jack Schwagger's Market Wizard books – *Market Wizards*, *The New Market Wizards*, and *Stock Market Wizards*. However, the first one is the best.
- Read some of the psychology book classics – *Extraordinary Delusions and The Madness of Crowds*, (MacKay), *The Crowd* (Le Bon), *Mindtraps* (Barach), etc. All of these are good starting points.
- Also read some of the classics on the history of the market – these would include *Reminiscence of a Stock Operator* (LeFevre), *The Book of Daniel Drew* (White), *Devil Take the Hindmost* (Chancelor). All of these are good examples.
- Also read some modern classics – Jimmy Rogers *Adventure Capitalist* is a good book and an interesting perspective and also read Leon Levy's book the *Mind of Wall Street*, Warren Buffet Essays (from his stockholder reports)
- I'd also recommend some good short term trading books such as *Street Smarts* (Linda Raschke), *Hit and Run Trading* (Jeff Cooper), *The Stock Trader* (Tony Oz).

I'm only scratching the surface here, and I'm also leaving out a lot of great books. Nevertheless, if you read these books, not for the strategies but for the beliefs about the market and to make generalities about systems, then you'll be in pretty good shape to develop something that fits you.

The main purpose here is to get some idea of the different strategies that people have to make money.

If you could summarize some of those strategies, just to make it easier for people, what would some of the key ones be?

This is an interesting exercise. Let's go for long-term strategies first. These are strategies that are designed to keep you in a position for as long as possible.

First, there is buy value. By value I mean buying something at a real discount to its worth. So if you buy a stock at 65% of its liquidation value, you've bought value. And we've got real estate and a stock market strategy like this in *Safe Strategies for Financial Freedom*.

Second, we have trend-following. And let me give you some caveats about trend-following. It's always best to 1) have the overall market moving in your favor and 2) to have a fundamental reason for the trend that you see. With that in mind, you buy (or sell short) something that's moving efficiently (i.e., without a lot of noise) in the direction you want. Furthermore, consider giving it a lot of room so that you can hang on for a long time. That's why the 25% trailing stops or three times volatility trailing stops are good.

I think those are the key long term strategies although there are a lot of variations of each of those.

What about short-term strategies? And here we are talking several days in a trade – the swing trading strategies.

One example that I can think of is band trading when you notice that the market seems to be moving within a specific range. These get a little tricky because you have to have a setup that says the market has reached an extreme (i.e., it crosses one of the boundaries of the band). You then need a trigger that says it has reversed and is moving in your favor (that's the entry). Typically, your stop loss point is quite narrow here. And then you basically look for 1) a target to be reached (i.e., the other end of the band); or 2) something that says the pattern no longer works. Since your stop is quite tight these can produce pretty good R-multiples of your initial risk (R).

In addition, knowing certain beliefs that most people have about the market, you can also set up good swing trades. For example, some of the common beliefs that will help you are

1) Support and resistance points;
2) Trendlines; and
3) Fibonacci numbers.

Now, these are all made-up ideas, but you can use them to trade if they give you good low risk ideas.

Before we get into that, perhaps you should define a low risk idea.

That definition has remained constant for me for some time. A low-risk idea is one with a positive expectancy that's traded at a risk level (i.e., position sizing) that will allow for the worst possible contingency during the short term so that one can realize the long term expectancy.

Can you give an example of that?

Okay, let's take a system that loses 80% of the time (i.e., 1R) and wins 20% of the time (10R). Thus, the system only makes money 20% of the time, but the winners are ten times as big as the losers. In this sort of system it's quite possible to have 20 losses in a row and you could begin with that. In fact, you have an 65% chance of having 20 losses in a row if you make 300 trades per year.

You also have a 9% chance of a drawdown as big as 30R, so you must be prepared for that. So let's say you simulate 300 trades with this system, and you consider a 50% drawdown to be failure – you'd stop trading. If you risk 4% per trade, you run a 4.8% chance of ruin; at 6% your chance of ruin jumps to 15%; at 8% it jumps to 26.3%; and at 10% risk your chance of ruin jumps to 37.3%.

This is a great system – you'd be up 360R on the average at the end of 300 trades. But it wouldn't be a great system if you risk too much. Instead, you'd experience failure. In fact, if you want no chance of failure, then you have to risk less than 2% on this system.

When you risk less than 2%, you might not get the great returns, but you don't risk failure with this system. Thus, it becomes a low risk idea. Hopefully, that helps you understand the definition.

Okay, and before we go back to various types of systems, can you talk about some of the basic principles that produce low risk ideas?

Sure, they've been said many, many times.

Trade within a framework that makes sense. For example, trading high-tech stocks made sense during the 1990s. It didn't make sense from 2000 to 2002 or now.

Before you get into any position, know your worst case risk which we call R.

Make sure that your system gives you a great positive expectancy. But some rough guidelines would be to make sure your system gives you at least a 50% chance of a 3R gain. You need to see the potential for that kind of risk-reward ratio before you take a trade.

Use position sizing to meet your objectives.

So with those principles in mind, describe several swing trading systems.

Well, most swing trading tactics involve trading for some sort of target. So let's look at a few examples of this.

- The market could hit a low and then start moving in the opposite direction. This might not be the primary trend, but the primary trend usually has retracements of 25%, 38%, 50%, or 62% — Fibonacci retracement levels. When you clearly can see what is happening. These can be your targets.
- The market can also retrace to natural support and resistance levels. These are points on the chart where the market has been before. For example, if the market has bounced off a high point of 53 twice before, as it moves up to 53, it's likely to meet significant resistance. That could be a profit taking target.
- Significant moving averages such as the 50 and 200 day moving averages that a lot of people pay attention to can also be significant turning points.

Notice that all I've done is list a few beliefs about the market which could set up target points for you. If these targets produce potential rewards that are at least three times your initial risk, then they probably make sense.

Okay, you told me when to take profits. But what kinds of short term systems are there.

Here's a list.

- First, you might have trend following systems. The first might occur when the market runs into resistance and then consolidates. After a while it might break out of a consolidation and that would be your signal to enter. You'd either trade this to a target or until a trailing stop was hit. You can call this a break out trend following system. William O'Neil's CANSLIM basically fits into this category.
- The next kind of trend following system might be to response to some sort of continuation pattern in the technical picture. These patterns might include flags or triangles. And, of course, you'd trade these to a target or until some sort of trailing stop was hit.
- You then have systems that involve a test of some level of the market and then reverses from that point. If you know how to spot significant types of tests, these are great methods. This is somewhat similar to the band trading that was mentioned earlier. A head and shoulders pattern is also a test.
- In addition, breakouts can sometimes be false and signal entry patterns. These would be another example of a test-and-fail type of system.
- Lastly, there are also systems where the market gets extremely overbought or oversold in the time frame you are trading. This might occur when you get climax moves. For example, towards the end of 1999

you could see stocks that would double in a week and then retrace 50% in a few days. However, this could occur on any time frame, even day trading.

Can you see the pattern here? And, if you use one of these types of systems within a framework that makes sense, you can make a lot of money.

And what's that framework again?

First, you need a big picture to support you. It's not necessary, but it certainly helps. Remember, as Steve Sjuggerud said in the interview I did with him, most ships rise and fall with the tide. Generally, you want the tide going in your direction.

Second, you need a framework out of which to trade. This means you set up some sort of model that gives you low risk trades. If you see the market trading in bands, then when the market goes through the band and then reverses, you've got a trade on with a very small initial risk.

Third, you need to be able to turn this trade into a significant R-multiple. If you are trend-following, then you might want to turn the trade into a 10R winner or bigger. If you are swing trading, then you want at least a 50% chance of a 3R or better. This is what gives you a positive expectancy.

And, lastly, you want to manage your total risk through position sizing. It's position sizing that really helps you meet your objectives.

Next month, we'll get into the steps in much more detail. We'll also talk about position sizing and simulating your system.

Who is To Blame?
Continued from page one

market was flat, but even that wasn't good. And we're in Super Red Light Mode right now. What do you think the likely outcome will be this time?

Well who is to blame, the Republicans or the Democrats.

The secular bear markets started in early 2000 when Bill Clinton was in office. I know the Democrats like to take credit for the super bull market that was going on during most of his administration, but can they? First, there was a whole series of Federal Reserve rate hikes in 1999 that could be blamed for setting off the first phase of the bear. But the bear probably would have occurred anyway. What goes up, usually comes down. That's a fundamental law of gravity and it applies to markets as well.

Yes, but we've had a nasty downturn during the Bush administration. Aren't the Republicans to blame for the severity of the market crash?

Well, during the Bush administration we had massive stimulation of the economy. Even though the market went down, we were never in midst of a recession. Perhaps you could say that Bush was responsible for the market fall not being much worse. But then again, the Federal Reserve just raised interest rates and that's what put us in red light mode. The market has been going down ever since. Perhaps it's Greenspan's fault?

So what is the overall state of the economy and who is to blame?

We have deficit spending that is basically out of control. It's hard to see how it can get much worse. But, of course, many people said that when the federal deficit reached a trillion dollars. Now, the real deficit, including future obligations, is over $35 trillion dollars.

Personal and corporate debt is not much better. Both sectors borrow like crazy so they can have it all now. And the net result is usually disaster.

However the primary culprit, if you must blame anyone, is the American public. Our constitution did not give the federal government the power to tax. But we changed that early last century. Over that last 50 years we, as a people, have given up more and more of our freedoms to the government by saying, "It's your fault, do something." What's that gotten us. Well here is a list:

- The social security system was only supposed to last until the Great Depression was over. Instead, most people now think of it as their security in retirement. In reality, it is nothing but a bankrupt system because the government has been spending your money. If you did what our government has been doing, you'd be sent to jail. But since our government makes the rules, they can do what they want as long as we permit it.
- Everyone wants the government to solve their particular problems. The government promises to do so and then forms a bureaucracy at great cost to the taxpayers. On the average it costs the government about $10 to do something that you as an individual could do for a $1. And everyone defends their own programs so there is no getting rid of the waste.
- We have a progressive tax system that penalizes free enterprise. John Maynard Keynes originally postulated that when people had two cars and a four bedroom house they'd stop working. As a result, the government, to encourage people to keep on working, decided to tax the wealthiest Americans at a rate that rose as high as 90%. The result, of course, was exactly the opposite of what was intended. And today, when this trend is gradually being reversed, it's called a "tax cut for the wealthiest Americans."
- And most seriously, we are giving up our freedoms. This country was founded upon the idea of "give me liberty or give me death." Today, we resist terrorism and give up our freedoms in order to do so. What happens is that we get whatever we resist. It's likely that not one American feels freer today now that we have a "Department of Homeland Security." Instead, what we resist persists — there probably are more terrorists today than three years ago. And we've given up a lot of our freedoms.

Both Democrats and Republicans have been responsible for this mess and I don't see how it's going to change with the two parties acting the way they do.

So what do we need to happen to make a difference?

People need to begin to assume responsibility for their own lives and the results they get. Vote for the candidates who are willing to give you back your freedoms and your personal responsibility rather than take it away from you. Right now this probably means voting for a third party candidate. Think what would happen if the minor parties started getting 20-30% of the popular vote. The impact would be tremendous. However, it all begins with you.

Who's responsible for deficit spending?

We are.

Who's responsible for big government?

We are.

Who's responsible for the gradual erosion of your freedoms?

We are.

Think about it. It's not the Republicans or the Democrats. Neither party is that different. They both reflect a gradual erosion of American freedom and a rise in the power of government. And who is responsible? — we, the American People.