Market Mastery Third Quarter 2005

This third quarter edition continues with material from Van's latest work the *Definitive Guide to Position Sizing and Expectancy*. This publication will override his existing work, the *Special Report on Money Management*.

Are You Doomed to Failure?

Yes, but Only if You Avoid Working on Yourself!

By

Van K. Tharp, Ph.D.

In my modeling work with good traders, I've generally found that the average person will do exactly the opposite of what is required for success. This is partly due to the way we process information. In fact, psychologists for the last fifteen years have studied the psychology of decision-making and risk, and concluded that we are very poor at both. Thus, it is not surprising that most people have trouble following "the golden rules of trading." (See the last issue of *Market Mastery* for more information about the Golden Rules.)

Judgmental Shortcuts

Why Judgmental Shortcuts Are Important: French Economist George Anderla found that the rate of information flow that human beings must cope with doubled in the 1500 years between the time of Jesus and Leonardo DaVinci. By the year 1750 (i.e., in about 250 years), it doubled again. The next doubling only took about 150 years to around 1900. The onset of the computer age, in the 1960s, reduced the doubling time to about 5 years. And, with today's computers offering electronic bulletin boards, DVD ROMs, fiber optics, the Internet, etc., the amount of information to which we are exposed currently doubles in less than a year.

Researchers now estimate that humans, with what we currently use of our brain potential, can only take in 12% of the visual information available. And for traders and investors, the situation is at an extreme. A trader or investor, looking at every market in the world simultaneously, could easily have about a million bits of information coming at him or her

In This Issue

"The secret to success is in understanding how these biases affect you and in turning yourself into an effective investor/trader."

- V. Tharp

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every second. And since there are usually some markets open around the world at all times, the information flow does not stop. Some poor traders actually stay glued to their trading screens, trying to process as much information as possible for as long as their brain will permit.

The conscious mind has a limited capacity to process about seven (plus or minus two) chunks of information at a time under ideal conditions. A "chunk" of information could be one bit or it could be thousands of bits (for example, a chunk could be the number 0 or a number like 7,941). For example, read the following list of numbers, turn the page, and then try to write them all down.

34 39 85 93 21 98 43 56 76 53

You probably couldn't do it because we can only consciously process seven (plus or minus two) chunks of information at one time. Yet we have millions of bits of information coming at us every second. And the current rate of information availability is now doubling every year. How do we cope?

The answer is that we generalize, delete, and distort the information to which we are exposed. We generalize and delete most of the information. "Oh, I'm not interested in the stock market." That one sentence takes about 90% of the information available on the markets, generalizes it as "stock market information," and then deletes it from consideration.

Psychologists have taken a lot of these deletions and distortions and grouped them together under the label "judgmental heuristics." They are called "judgmental" because they affect our decision making process. They are called "heuristics" because they allow us to sift through and sort out a lot of information in a short period of time. We could never make market decisions without them, but they are also very dangerous to people who are not aware that they exist. They affect the way we develop trading systems and make decisions about the market.

The primary way most people use judgmental heuristics is to preserve the status quo. We typically trade our beliefs about the market and once we've made up our minds about those beliefs, we're not likely to change them. And when we play the markets, we assume that we are considering all of the available information. Instead, we may have already eliminated the most useful information available because of our selective perception.

Interestingly enough, William Eckhardt points out, in his chapter of *The New Market Wizards*, that progress in knowledge results more from efforts to find fault with our theories rather than prove them. If his concept is true, then the more we tend to realize our beliefs and assumptions (especially about the market) and disprove them, the more success we are likely to have making money in the market.

Thus, what are the beliefs and theories that need to be disproved for us to make progress? These beliefs represent many of the biases that we must overcome in order to make progress.

> *The secret to success is in understanding how these biases affect you and in turning yourself into an effective investor/trader. If you try to project what you learn outside of yourself onto the market, you will not be able to apply any of these principles we teach in this report. Money is made*

through the personal application of these principles.

The Locus of Control Bias—the Lotto Bias

This particular bias has to do with the need for control—a need we all seem to have, so investors try to focus on that area of investing in which they think they have the most control, picking the right stocks. However, it's really just a bias.

This bias is particularly evident in the lottery game, Lotto. Almost every government that runs a lottery plays the game Lotto. And, just in case you are not familiar with it, you buy a card and you get to pick some numbers—usually seven of them. If the numbers you pick match the numbers that are randomly drawn, then you win the big multi-million dollar prize. People are quite willing to play this game in large numbers because 1) they have the potential to turn a dollar investment into a multi-million dollar prize (but it is a negative expectancy game), and 2) they get to pick the numbers, any numbers they want.

Being allowed to pick any numbers you want in the Lotto game is what gives it its appeal. In fact, there is a whole industry that has sprung out of helping people pick the right numbers. First, there are actually services that help people pick numbers. They are cheap—only a dollar per pick—and they basically give everyone a different number. But if they help someone win, they'll make a million dollars in the next lottery. Second, there are people who'll read your astrological chart and help you pick the right numbers. Third, you can buy software that will analyze previous numbers that have been picked so you can discern patterns and make better picks. And fourth, you can even buy software that will randomly generate numbers, just like the machine, so you can pick one of the randomly generated numbers. On top of that, remember that the lottery usually announces the store at which the last winning number was sold and when they do, people flock to that store to buy tickets to the next lottery.

Does this all sound a little familiar? It should because it is very similar to what happens in the stock market. People think that winning the stock market game has everything to do with picking the right stock. About 30% of all books on how to make money in stocks have the word "picking" in the title. Television shows related to the market frequently bring in fund managers or analysts and what does the host ask them? "What stocks are you picking for us today?" They might also give the track record of the person being interviewed.

> Last time Mr. X was on the show he picked XY and it's up 12%. He also picked CV, but it's down 26% and he picked TY and it's down 18%. What happened, Mr. X? You didn't do so well last time.

Notice how the presupposition in all of this is that it's all about picking the right stocks. The logic that says that success is all about picking the right stocks is so deep that mutual funds are always at least 95% invested—because they feel they are paid to pick the right stocks and keep your money working for you. Furthermore, analysts are paid huge six figure salaries and their only job is to analyze the balance sheets of the companies they research so that they can pick the right stocks. And, by the way, I have yet to meet an analyst who has managed to become a good trader. Some of them are okay as a manager of a large mutual fund, but very few become good traders.

Thus, the average investor, armed with this bias that he can control his/her success by just picking the right stocks, finds himself or herself in a world in which picking the right stocks is emphasized by everyone. So when they lose money, they just assume that they picked the wrong stocks or that someone else (who was giving them advice) picked the wrong stocks. And what typically happens? The average investor *NEVER LEARNS SOME OF THE KEY FACTORS THAT ARE REALLY IMPORTANT FOR SUCCESS—namely,* the **Golden Rules of Trading**.

What should you do about the lotto bias? In this particular case, realize that you also have control over your exits. You can exit at your predetermined stops and almost guarantee that your losses will be 1R or less. You can use trailing stops to let your profits run. This will almost guarantee that your profits will be greater than 1R. And if you follow these rules, pretty soon the returns that you generate will be enough to convince you of the wisdom of the Golden Rules of Trading.

The Need to Be Right Bias.

The educational process in most industrial countries came about, not to really educate our children, but to develop good workers for our factories and other businesses. When most people worked in agriculture, we didn't need a great educational system—it was just for the chosen few. But now we need "educated workers" to help with our businesses. Sure, we want these highly skilled workers to be able to think and come up with new ideas. But we also want them to be good employees and do what the boss wants them to do. So how do we do that? We do it through our educational process, where children learn that the teacher is always right.

Children go to school for 12 to 16 years and the primary thing that is emphasized over and over again is that the teacher is always right. For example, as a child in school, you have to take tests. You learned that if you got less than 70% right, you are a failure. And you don't get an excellent mark, an A, unless you get 94% correct or better on your test. And perhaps you get 96% correct and come home with an A- score. When you showed it to your dad, he asked, "Why didn't you get 100?" So your dad wanted you to be right as well.

As a result, we grow up with a passionate need to be right. If you are not right at least 70% of the time, you are ostracized as a failure. But you want to be right 100% of the time so that your dad won't criticize you.

Now, let's apply that to the stock market or to the futures market or to any other investment you might make. You want to be right and to you that means making money. Let's say you buy a stock for $50 and let's say you also understand the concept of setting a stop loss and decide you'll get out if it drops to $45 per share.

But let's say, it drops to $45 per share. You really want to be right, so if you got out you'd be wrong, or at least feel as if you were. You feel wrong taking the loss and so it's very difficult to follow the stop. All sorts of dialogue goes off in your head:

> "It's just a temporary setback. The analysts are predicting a great increase in the earnings this quarter—I can't sell now! What if this downturn is just a few traders manipulating the market? I think I'll hang onto the stock and not sell—at least for a few days."

So you hang onto the stock and watch it fall even further. It drops to $40. Now you have a 2R loss. If it was hard to take a 1R loss, it's even harder to take a 2R loss. And all the same arguments apply. Thus, you hold onto your stock.

Now the stock drops to $35 and you have a 3R loss. You know you really should get out, but now you notice that your portfolio is down $4,000. You can only write off $3,000 in losses, so you'd better keep this stock. You know it will turn around. However, you have a good solution to keep away the anxiety of watching yourself lose money. You won't watch it anymore. You'll look at it in six months. By that time, perhaps you'll have made a lot of money.

There is an old joke about the man who was dreaming about the EVIL that was stalking him. It kept getting closer and no matter how fast he ran, it got nearer and nearer. Finally, when EVIL was almost on top of him, and he felt sure he was doomed, he turned to plead for his life. And what did he see? He saw the postman handing him an envelope, saying, "It's just your brokerage statement."

Perhaps, now you can understand why two psychologists won the Nobel Prize in Economics for basically showing that it was very hard for people to take losses. People, according to those psychologists, become much more "tolerant of risk" when they are behind. Obviously, people have trouble cutting losses short. But that's only half the golden rule. The other half is to let your profits run.

So let's go back to our bias—the need to be right. What happens when you are right about your investment and it starts to go up? The golden rule says let your profits run—let it go up more. But you have a strong need to be right. Your $50 stock has gone up to $55 and if you sell now, you'll be right and have a profit.

However, you know you should let your profits run and to do that you've got a 10% trailing stop. Now that the stock has reached $55, you won't sell it unless it drops $5.50 to $49.50—your trailing stop level. However, suddenly your stock starts to drop. It drops to $54 and then to $53. You get nervous because your profit is slipping away. Now it drops to $52 and then to $51. You feel tied up in knots. It's getting close to your stop and if you get stopped out, you'll have another loss. You'll be wrong. Suddenly, it drops to $50.50, and that's enough for you. You sell the stock quickly for a $0.30 profit after costs. You really feel proud of yourself because you made money.

So what just happened here? Our investor, because of his overwhelming need to be right, sold out for a minimal profit. The stock actually dropped to $49.90 and then turned around and kept going until it hit $75. But our investor was happy because at least he didn't lose any money.

Now, notice what he's done here. He's cut his profit short and let his loss run. And isn't that exactly the opposite of the golden rule of trading? What do you think your trading profits would look like if your results were as in Table 1.

Because of the bias to be right, our investor has managed to only have three losers. But those three losers total -10R. Our investor is right 70% of the time with seven winners. However, those seven winners total

Table 1: Typical Investor R-multiples with Need to be Right	
Trade #	**R-Multiple (gain/loss)**
1	+0.1R
2	-3R
3	+0.2R
4	+0.2R
5	+0.4R
6	-4R
7	+0.2R
8	+0.1R
9	+0.3R
10	-3R
Total	**-8.5R**

+1.5R. And the net result of our investor's bias to be right is that he is down -8.5R for the ten trades. Thus, if he were investing about 1% in each trade, he'd be down about 8.5%. Not a very good result for someone who was right 70% of the time—just above the "failure level." And as he wonders what went wrong, he thinks to himself, "Perhaps I picked the wrong stocks."

Yet, let's look at the opposite situation. Let's say that our investor made money three times out of the ten trades, two 3R gains and one 4R gain. He lost money seven times out of ten—all 1R losses. This is shown in Table 2.

What's the net result for this person? Well, he is right 30% of the time, but the net result in terms of R is +3R. Had he risked 1% on each trade, he would have been up about 3% at the end of 10 trades. Now can you begin to see why this need to be right bias can be so deadly to your bottom line?

So now we have both halves of the research done by the two psychologists who won the Nobel Prize in Economics. People tolerate risk more when they are behind (i.e., they won't cut their losses) and the tolerate risk less when they are ahead (i.e., they won't let their profits run). And the net result is most people have trouble making money in the market.

So what can you do about your need to be right? Instead of focusing on being right, focus on not making any mistakes, where a mistake occurs when you don't follow your rules. Your rules should be the golden rules of trading:

- Always know your exit point, that point at which you'll get out in order to preserve your capital, before you enter a trade. And if you don't take such losses when they occur—consider it a major mistake.
- Always keep some sort of trailing stop so that you can let your profits run. And if you find yourself taking profits too quickly, just to make sure you don't lose money. That's another major mistake.

If you consider breaking these rules as being wrong (i.e., making a mistake), you'll find that suddenly you can make money—big money—in the stock market or any other investment field.

Table 2: Typical Investor R-multiples Following Golden Rule	
Trade #	**R-Multiple**
1	-1R
2	+3R
3	-1R
4	-1R
5	-1R
6	+4R
7	-1R
8	-1R
9	-1R
10	+3R
Total	**+3R**

Looking at the results as a percent gain for your portfolio, instead of as an R-multiple for the trade.

Imagine the headlines. . .

. . .If you'd taken this recommendation, you'd have been up 150%.

. . .If you had taken all of my recommendations this year, you would have turned $10,000 into $40,000

. . .XYZ, after I recommended it, went up 300%.

What happens when each statement is made is that *you see your entire portfolio being up that much.* Instead of thinking XYZ went up 150%, you think of your portfolio as being worth $250,000, rather than $100,000. However, that would only occur if you invested everything you had in that particular stock and managed to get the exact amount of profit that was reported. And what's wrong with that logic? If you invested everything in that particular stock, your risk would have been huge. No one should take that kind of risk on a single stock.

But let's look at what a stock being up 150% really means in terms of an R-multiple. Let's say you bought the stock with a 25% trailing stop. You bought it at $10 per share with an initial stop loss at $7.50. The stock is now up 150%, meaning it is now up to $25 per share. You have a paper profit of $15, compared with an initial risk of $2.50, which means you are really up 6R in the stock. Just because the stock is up 150%, however, doesn't mean that you've sold it. At $25, your trailing stop is now at $18.75. Hopefully, it'll go up more. But if you get stopped out, your total profit shrinks to $8.75. When you compare this with your initial risk of $2.50, it means you have a 3.5R profit. And that means if you risked 1% of your equity on the trade, you will make 3.5%. That is a far cry from thinking that your portfolio has moved from $100,000 to $250,000—but that is what most people envision when they read the headline, "If you invested in this stock, you'd be up 150%."

Are you beginning to see how this bias works? More importantly, can you see how much better your thinking would be if you starting thinking of your results in terms of R-multiples or risk-reward ratios?

Let's look at the next example—"If you had taken all my recommendations this year, you would have turned $10,000 into $40,000." This is another real headline from an advisory service. However, when I made some inquiries as to what it really meant, this was the answer:

> If you had risked $10,000 on every trade recommendation that was made this year, then at the end of the year you would have been up $40,000. If you now translate that into R-multiples, the statement becomes—"If you had taken a 1R risk on each recommendation during the year, then at the end of the year you would have been up by 4R." Let's say that this advisor made 20 recommendations. What that now means is that the expectancy of his trading recommendations was a paltry 0.02R.

Thus, when you look at the original statement you see your account up 400%. When you demand enough information that you can start thinking in terms of R-multiples and expectancy, you discover that this is a very poor system with an expectancy of on 0.02R. And if you risked 1% on every trade, you'd only be up 4% at the end of the year.

Now let's look at the third recommendation, "XYZ, after I recommended it, went up 300%." Again, with this one you see your account up 300%. However, let's assume that in this case it was an option trade. Your risk was the entire amount of the option contract. Eventually your profit became three times your initial risk, but since your initial risk was everything, your net profit is a 3R profit. Thus, we suddenly move from seeing our portfolio up 300% to realizing that we are probably up 3% because of this one trade.

And, when an adviser tells you about all of the trades that went up 200% or 300%, they are not telling you about all of the losses. Thus, you have no idea about the real expectancy of the system or the real performance of the portfolio.

So let's say an advisor makes the recommendations in Table 3. . .

During a period of six months, the advisor's overall track record is down 1R. What does he tell you? In April we bought CREE and sold two months later for three times what we paid for it. We also bought Apple and sold it for a nearly a 300% gain. Wouldn't you like that kind of success?

And what's your reaction to that? Wow, I could have bought CREE and tripled the value of my portfolio in two months. Would you have? If you had bought the entire portfolio, as recommended, you'd have been down. But the advertising doesn't say anything that is incorrect. It just leads you to think that their performance is much better than it really is.

Recently, a merger was announced in which Valero was planning to buy out Premcor and become the largest refinery in the United States. One advisor had both stocks in his portfolio earlier in the year. However, both stocks were stopped out of the portfolio a week or two prior to the

Table 3: What if Your Newsletter Had the Following Recommendations?		
Trade Recommendation	**Result of Trade**	**R-Multiple**
Buy GE at $38	Loss to $28	-2R
Buy IBM at $60	Loss to $50	-2R
Buy GM at $45	Loss to $40	-1R
Buy CREE at $15	Gain to $45	6R
Buy VLO at $75	Loss to $67	-2R
Buy TSRA at $41	Loss to $29	-3R
Buy BHP at $65	Gain to $75	2R
Buy AAPL at $28	Gain to $82	8R
Buy WRF at $33	Loss to $16	-5R
Buy HD at $64	Loss to $58	-2R
	Total Gain/Loss	-1R

merger. However, when the merger was announced, this is what was sent to potential subscribers.

"One of our stocks recently bought out another one and both stocks had huge jumps in price on the announcement. You could have made huge profits in both of these stocks had you followed our recommendations."

Again, can you see how this bias would hurt most people? However, in this case the solution to the bias is simple. Don't believe anything anyone tells you unless they can show you their track record in terms of R-multiples! Otherwise, they are just telling you about a portion of their recommendations and framing it so you imagine huge gains.

As a result, we recommend that you convert everything that people tell you about their performance into R-multiples. What was the initial risk? What was the risk-to-reward ratio (i.e., R-multiple)? Determine the expectancy and then see what really happened. And if you do, ask, "How does that expectancy compare with other expectancies I've seen?" If they are telling me I'll be up 11R at the end of the year, it says that I probably would have been up 11%.

Amount of Information Bias

Another significant bias is the amount of information to which you are exposed that says "stock picking is important." Typically, the more often people are exposed to certain information, the more likely they are to believe it. Yet, it could be the same information (i.e., from the same source). For example, someone develops a story about how some guru made a fortune picking the right stocks. Let's say that all of the news wires carry the story, so you read four different versions of the same story written by four different people. Now, one source concocted the story, but because you are exposed to it four different times, your conclusion is "it must be true."

Sources which claim that picking stocks is important are all around us. For example, I looked up "picking stocks" in Amazon.com and the inquiry returned 158 items. Several of them included:

- *How to Pick Stocks Like Warren Buffet* by Timothy Vick
- *Pick Stocks Like Warren Buffet* by Warren Boroson

Notice how there is an assumption here that Warren Buffet, considered by many to be one of the world's greatest investors, makes his money by picking the right stocks. However, Warren Buffet didn't write the books—other people did. But using his name and including "picking stocks" in the title makes it seem as if the key to success is picking stocks. And you don't have to read the book to assume that—you just have to look at the title.

Here are a few more:

- *Michael Sivy's Rules for Investing: How to Pick Stocks Like a Pro* by Michael Sivy
- *How to Pick Stocks* by Fred Frailey
- *World's Greatest Stock Picks of All Time* by W. Randall Jones
- *Investing Smart: How to Pick Stocks with Investor's Business Daily* by Dhun Sethna
- *Pick Winning Stocks* by Edward Mrkvicka.

There are many more books with stock picking in the title. These are just to show you how prevalent the bias is.

However, the topic is even more prevalent on television.

- Wall Street Week always has its panel of experts who pick the stocks they like.
- CNBC has programs like "Stock Picking Friday." However, stock picking is predominant on CNBC and I have never heard a single analyst say, "I like this stock, but I'd sell it if it dropped to this level."
- Bloomberg TV will also interview experts and ask them which stocks they like.
- CNNfn (which no longer exists) would frequently interview people to find out which stocks they are recommending.

And the list goes on and on. If you only watched television to determine how to invest, you would be sure that the key to successful investing was picking the right stock.

The Authority Bias

We also have another bias in which we believe people who have some authority. If the analysts say so, it must be true. I actually pointed it out in the last bias. Two books on picking stocks had to do with "how Warren Buffet picks stocks." In fact, there are nearly a dozen books that have been published on Warren Buffet. I actually covered some of his style of investing in *Trade Your Way to Financial Freedom*. Furthermore, every author makes the assumption that Buffet's success is because he is the key stock picker. And if Warren thinks it's so, we believe it must be so. However, Warren Buffet has written none of those books and I'm sure that if Buffet told the truth about how he invests, he'd also emphasize his exit strategy.

People also assume that when analysts and fund managers talk about how important their stock picking is that these people are authorities. Consequently, it also carries a lot more weight when these people give an opinion.

This bias is quite ironic, because many studies have shown that when authorities are asked for an opinion—especially if there is a consensus among many authorities—they are usually wrong.

Prediction and Understanding Bias

One key belief is that it is the need to understand. One of my clients, Joe, claimed that he had the most difficulty with the market when he got into a position and didn't understand what was going on. As a result, I asked him a number of questions. "How often are your positions winners?" His response was that he was right about 60% of the time. "When you don't understand what's going on, how often do you come out a winner?" This time his response was that he almost never came out a winner when he didn't understand. I then said, "Since your system isn't much above chance, you probably don't understand that much about the markets anyway. But when you clearly are confused, you should just get out." He agreed it was probably a good idea.

When you think about Joe's trading system, however, he really didn't have one. Why? Joe was so concerned about understanding that he didn't have clearly defined exit signals that told him

1) when he was wrong so he could get out, and

2) when to take his profits.

Most people still need to make up elaborate theories about what is going on in the markets. The media is always trying to explain the market even though it knows nothing about it. One day I watched a 91.52 point drop in the Dow. The next day the newspapers were filled with statements like:

> *"Investors, spooked by prospects of an economic slowdown, switched en masse Tuesday to what's become an alluring bond market. The stock market sell off was accelerated by computerized program trading. . . .Money managers are making a major shift all at the same time, that's why we're seeing such a heavy surge now. When it fell, it triggered a rush of computerized selling. . . .Wall Street now believes that the latest Fed rate increase will slow the economy. That's good news for the bond market, which hates inflation because it erodes the value of fixed interest bond payments. But it's bad news for stocks. There's a growing perception that maybe the rising rates we've had could have an impact on the economy, which could lead to some corporate disappointments."*

The "need to understand" bias becomes even more elaborate when it comes to trading system design. People manipulate daily bars in any number of strange ways and then develop strange theories to explain the market based upon those manipulations. The resulting theories then take on a life of their own, but have little basis in reality. For example, what is the rational basis for the Elliott Wave Theory? Why should the market move in three legs one way and two legs the other?

When you think about academic theories about the market, those theories are all based upon predicting the market. Fundamental analysis is devoted to determining the fundamental characteristics behind the market. Some people believe that when you understand these fundamentals well enough, you can trade well because you know the factors influencing the market. In fact, most academicians believe that the markets are totally efficient—if you could just understand the fundamentals. Anything else that might affect the market is just considered to be random noise.

Some people rebelled against fundamental analysis and developed technical analysis. Technical analysis amounts to trying to predict the market by looking at pictures of price bars from the market's past. Market technicians believe that if you draw enough lines and observe enough patterns, you will eventually be able to perfectly predict the market.

Now that the stock market has 500-point moves with some regularity—suggesting that the market is not efficient and random—a new field of study is beginning to replace fundamental analysis. That new field is called behavioral finance. It attempts to predict changes in the market by studying the inefficiencies in human decision-making. In other words, psychologists and economists study some of the same inefficiencies that I am pointing out to you in order to be able to determine why the market is so unpredictable. However, the value in understanding these judgmental heuristics comes from neutralizing how they impair you. When they no longer impair you, then you have a chance to make very high return rates with low drawdowns.

I went to a conference on psychology and the markets in Frankfurt, Germany in 1997. Numerous presenters talked about various ways that human decision making was flawed and how that might be better used to predict the markets. One even said that what our traders were doing was impossible—no one could consistently make over 50% in the market. All of the presenters missed the point. People don't make money by predicting the markets. They make money by *cutting losses short and letting profits run* and by using proper position sizing to accentuate those effects.

The secret to success is in understanding how these biases affect you and in turning yourself into an effective investor/trader. If you try to project what you learn outside of yourself onto the market, you will not be able to apply any of these principles. Money is made through the personal application of these principles

Are you beginning to see the importance of this kind of thinking and the many, many problems behind it?

There are many biases that influence how you pick the right stock besides "the prediction and understanding bias," the "authority bias," and the "amount of information bias." The keys to success lie not in understanding these biases, but in the biases that make you think that this area (i.e., picking stocks) is so important.

Other Biases That Influence Being Right

In the remainder of this article, I'd like to focus on the issue of wanting to be right. It's often been said that most traders would rather be right than make money. So let's explore what causes this to happen.

So now imagine someone who desperately wants to make money in the markets. It's this person's passion. He gets a software pack that has lots of charting ability and looks at chart after chart after chart.

He looks at the big moves in the market, wondering what those moves have in common. First, he notices that many big moves follow a consolidation period—not always—but often enough that it catches his eye. So his first trading idea is to trade moves out of a consolidation period.

But how do you know what's a real move or not. Suddenly, it hits him. There is a four-bar pattern that seems to occur on about 70% of the patterns he sees. That's it, he exclaims, and a new trading idea is born.

Now while this process might be better than what the average person does—who buys investments simply because of a news story or a guru recommendation—it still has some major flaws in it.

The Law-of-Small-Numbers Bias: It's Easy for Us to Invent or See Patterns

If you want to find something, such as a pattern that will lead to a big gain, it's easy to do so. Our minds naturally gravitate toward finding what we want, so much so that we create it out of chaos. As a result, we tend to see patterns where none exist, and it only takes a few well-chosen patterns to convince people that the pattern has meaning. In the example given above, our trader found a great pattern that he thought would lead to success. In reality, he only found six examples of this pattern, but that was enough to convince him that the pattern was real and decide that he had a trading system.

However, here's what he was missing:

- He only saw the six patterns that worked and decided it was real. What he didn't do was look at several hundred consolidations to see how often the pattern appeared and whether it always preceded a new trend. If he can come up with data that said, "Out of 300 consolidation periods, this pattern appeared in 213 cases prior to a new upmove," then he would at least have a reasonable idea that the move was real. It occurred 71% of the time.
- Second, and this is a common bias, he didn't look for how often the pattern leads to failure. How often does it occur and not lead to an upmove. Does it occur in non-consolidating periods? How often and what happens? For example, he might have developed a computer program to screen his data and found that the pattern occurred with some regularity. About once every ten days. Thus, in the same time period that he found 213 patterns leading to up moves, there were actually 7124 other examples of this pattern that did nothing. Suddenly, we have a pattern that only works about 3% of the time.
- Now this problem might be fixed by saying, "I'll screen for a consolidation pattern first and then look for the four-bar pattern." This might make it workable. But there is still the question of how often does the pattern appear in up moves? And when you check this out, it turns out that in the 300 consolidation moves there were also 732 examples of the pattern. Thus, while 213 of them lead to up moves, the other 519 examples, lead to nothing.
- At this point, the pattern doesn't look so good at all. But even if it did, we'd only have one part of a trading system—a filter and an entry. A full trading system also needs a worst case stop, an exit plan, and good position sizing.

So now you have some idea of what the mind can do when you want to be right and you don't consider all of the issues involved in good trading.

Furthermore, people only see the patterns that lead to success and not the patterns that lead to failure (i.e., big losses). Imagine what this one could do to convince you to buy a stock with a certain pattern.

Once We Think We've Got It, It's Hard to Get Rid of It

Once you believe you have found a pattern and become convinced that it works (by means of the law of small numbers bias), you will do everything you can to avoid seeing evidence to suggest that it doesn't work. For example, once you've found the pattern described above, most people would be very reluctant to see any sort of evidence that says it doesn't work.

When you read the example above, you probably say to yourself, "Sure, it's really important to do all of those things to determine if what I've found is meaningful." But the bias most people have is to totally avoid doing anything like that. Once you've found it, you don't want to know that you really haven't.

There are numerous examples of this, including:

- If you believe that stock picking is the key to success, you'll avoid evidence that suggests it doesn't work.
- If you think you can make money with options because of the high leverage and limited risk, you'll keep trading options despite loss after loss after loss.
- I've even seen traders who develop a specific arbitrage strategy that has given them a real edge. They trade it and make a small fortune and then the strategy stops working. They'll even tell me the strategy no longer works, but because of this bias they must keep trading it and lose a lot of money. Perhaps they need real-world verification that the strategy doesn't work.

Representation Bias: It Might Not Be What It Seems

Now let's look at another bias. Is it what it really seems to be? As someone trained in biological psychology, I can tell you without knowing about such biases that it is not. Our brain just sees patterns of light that trigger cells to go off. We don't know that something is a book or a ship or a barchart until we are trained to recognize it.

For example, if you saw the movie, "What the Bleep Do We Know," there was a long discussion of the fact that when Columbus approached the new world, the Native Americans could not see his ships. They were there, but they had no representation of what a ship is, so they just didn't see them.

So how does this pertain to investing? When people see a pattern in the market, is it really that? We already saw this example play out with the law of small numbers bias. But let's jump further into what we are actually doing.

When something is supposed to represent something, people assume that it is that thing. For example, when people see something like the chart below, they just assume it represents the market. First, the description says it is a chart of the S&P 500 so it must represent the market. But does it?

Think about it. That chart collapses months of data into simple bars on a page, but you are willing to assume that it represents the market. Do

you really know what was going on? Who bought and who sold? Who wanted to buy and who wanted to sell? Or more importantly, what's going on right now? We assume that it is somehow in that chart. But that chart isn't the market. The chart is a representation of the stock prices presented in some easy to understand manner. And a lot of information is deleted from that bar chart.

However, when we start to think things that represent something really are that thing, our thinking becomes distorted. And most people take it one step further because they do things to the data (e.g., draw trendlines; determine Fibonacci numbers; determine moving averages), which they think represent the market even more. But in reality, the more transformations you do on data, the less likely it is to represent the market.

Of course, you might already be thinking "Van is full of it for making such statements. Of course, that represents the market!" But isn't that the prior bias acting in your head?

The only safeguard I know of for this bias is to step back from everything, be in the "now," and just notice what is really happening.

If You Say So, It Must Be So

The last bias I want to cover here is that when we get information from other people, we assume that it is real. And if the information comes from an authority (i.e., Alan Greenspan), then it must be real *and* significant. Or if the information comes from many sources, then it certainly must be real.

Let's look at this from several levels. First, when you get data through a website or a data vendor, you assume that it is accurate. Yet clean data is a major problem for some vendors because you frequently get errors that can lead you to false conclusions. But that's all it is—an error.

When you read a news story, you assume it is accurate. But most reporters hear something, go to several sources to check it out (and all of those sources may have retrieved the information from the same initial source) and then pass it on to you. And if you hear the story from four different places, you tend to assume that it is more valid.

And when someone predicts future earnings, you also assume that it is fairly accurate. However, unless you assume that errors can exist in this information, you are doomed to make lots of mistakes in your trading and investment decisions.

I've always recommended that your business plan for trading include worst case contingency planning, part of which should center around this particular topic. What if something I think is real, really isn't real? What are the implications for my trading?

Conclusion

Perhaps you can begin to see why I tend to gravitate toward the position that everything is psychology. The more you understand this, the more you can begin to realize that at some level you are responsible for everything you experience.

And in my opinion, that's the first key to being a great trader. You must own your own performance.

Books I Really Like

By

Van K. Tharp, Ph.D.

We love to get your input about what you like and dislike, and one of the requests we've had is for more input from me on the books I really like. As a result, I thought I'd do a brief article on books that I recommend. And I'm going to do this in three categories:

1) Trading Related;

2) Psychology; and

3) Spiritual.

So let's start with the trading related books first. These books are not recommended in any particular order; they are just in the order in which I thought of them while deciding what I wanted to recommend.

Trading/Investment Books

1) Stock Cycles by Michael Alexander

I'm very interested in the big picture. I've seen so many people come and go in the trading arena because they didn't pay any attention to the big picture. In this book, Alexander does one of the best jobs I've ever seen looking at stock market cycles (over the last 200 years) and presenting a pretty good argument for their existence. And I'm saying this because it's clear from his book that we are in a secular bear market and it could last another 10 years or longer.

So why do I recommend this book? Just for the perspective you'll get when reading it. Flowers don't bloom all year round and neither does the stock market, so it's quite useful to get a big perspective.

What the book lacks is a discussion of what to do in a secular bear market, but I recently discovered that he has a new book addressing that subject (*Investing in A Secular Bear Market*) which I've just ordered.

Also, I'd strongly recommend that anyone interested in this book go to the web site of Crestmont Research, which is www.crestmontresearch.com and download the various reports available there. The reports on financial physics are fascinating. Also Ed Easterling, the web site's creator, has written a new book entitled *Unexpected Returns: Understanding Secular Market Cycles.* Again, I've ordered this book but haven't read it yet. By the way, I'm not recommending the books I haven't read, but just letting you know that there are more books on the same topic if it interests you.

2) *The Stock Trader* by Tony Oz.

Tony Oz actually sent me a copy of this book. It has just taken me a long time to get around to reading it. Now, this book isn't for everyone because its mostly about day trading; however, it gives a fascinating view into the mind of a fairly successful trader.

I also think this book is interesting because it shows that protecting yourself as a day trader isn't so much a matter of position sizing, but of making sure you manage your exits. For example, if you have tight stops day trading an expensive stock (as Oz does), you couldn't possibly risk 1% in your account—it would be way too many shares. Instead, Oz exits almost immediately when the trade goes against him with no regrets or looking back. He just gets out.

Oz also sets profit targets, but I noticed that he almost always exits prior to his targets because he's ruthless at protecting a profit. In some respects, this is the opposite of what I tend to prefer, but it works if your mentality is

1) short term trading;

2) a desire not to lose (get out almost immediately on losses); and

3) protect profits at all costs.

Consequently, I recommend this book just because it's a different perspective and it might just fit you.

"This particular book was pratically forced on me because three different people sent me copies and said, "You must read this book."

- V. Tharp

3) *Fooled by Randomness* by Nicholas Taleb.

This particular book was practically forced on me because three different people sent me copies and said, "You must read this book." If that isn't a hint to read something, I don't know what is. However, it still took me over a year to get to it.

This book might not be for everyone because it's about the role of chance in the market and to comprehend the material you really need to understand some statistical concepts. However, Taleb has a way of expressing these concepts in easily understandable ways.

I tend to believe that if you want to trade, you really need to have a grasp of certain math fundamentals—especially probability. And this book will help you grasp that. Here is an excellent example:

> Assume that you have ten thousand people who flip a coin to decide their best investment for the next year. At the end of five years, you'll have 313 who have been correct every year (i.e., the probability of 5 wins in a row in a 50% system is 3.13%). Those five people are probably the kings or queens of Wall Street and they absolutely believe that they have found the secret to successful investing. I know, I've met some of them.
>
> But what will happen the next year? Half of them will blow up (especially if they don't understand position sizing. . .which they don't). And which ones are the most likely to blow up? Probably the one's that you are the most attracted to and the ones that you are most likely to invest your money with.

Okay, it took me a year to recommend this book, perhaps longer. But you should put it on your desk and read it. Many of you should probably read it several times.

4) *Against the Gods* by Peter Bernstein.

Over the centuries, people have been obsessed by risk. And the more people could control risk, the more risk they could take. Originally, people thought risk was all due to the gods—the gods punished you by causing you to lose.

I'm always fascinated by the way people view statistics and risk. For example, there are so many judgmental shortcuts relating to risk that if you want to become a con artist, all you would have to do is study a number of these biases and it would be easy to get someone to hand you their money.

But, according to Bernstein, it was even easier 1000 years ago. People didn't understand probability or risk at all. So anyone who did could master the world. And as a result, the development of mathematical tools to predict odds was a major factor in the growth of commerce.

For example, early commerce by sea was a dangerous business. Ten percent of your ships might totally disappear—which means you'd lose everything you'd invested and also never see the crew again. And if you understand that something has a 10% chance of occurring, you might also understand that it could occur two to three times in a row. Thus, you could easily lose everything if you bet it all on one ship. (Incidentally, doesn't this sound a little like position sizing). Now the early merchants didn't figure out how to do position sizing, but they did figure out how to get someone else to pay for their risk. You would simply pay someone else a fee if he'd take the risk that your ship didn't come back. If you lose one ship in ten, you could pay him 12%. He'd make a profit, but you'd no longer be taking on any risk. It would just be a business cost. In fact, you could now take on more shipping risk. You'd be better off. Those taking on the risk would be better off (assuming they did enough deals to offset the short term risk). And the entire economy would grow.

So over time, we've developed all sorts of tools to help us manage risk—insurance, derivatives, and various risk management tools. Today, you can even buy insurance on the loans you make as a bank.

Since you are a risk manager as a trader/investor, I strongly recommend that you read this book just to get some perspective. Where did it all come from? Where would we be without it? And how well do you really understand and manage risk?

I was originally going to recommend at least five books in each category. However, all my trading books are at the office and I'm writing this at home. I'm sure if I looked through my library I'd probably come up with a dozen more books to add to the list. However, sitting here at home and giving it some thought, I haven't been able to come up with one other trading/investing book that really hits me as a "You must read this book." Thus, I am stopping at four.

Psychological Books

Let's move on to psychological books. I've got lots and lots of books I like, but I'll only give you five. That means I really have to think hard to decide which I like best.

1) *Happiness is Free and it's Easier Than You Think* by Hale Dwoskin and Lester Levenson

This actually isn't one book, but a series of five books. And I'm so impressed with it that I bought five sets of the series to give away as gifts. And I also must admit that I haven't finished reading the whole series. Instead, I'm recommending it just based upon my experiences with the first book.

"But, Van, how can you recommend a series you haven't finished?"

"If the remainder of the series is 1/10th as powerful as what I've already experienced, it will still be incredible."

- V. Tharp

It's simple. If the remainder of the series is 1/10th as powerful as what I've already experienced, it will still be incredible. In fact, my experience with the first week in the first book is enough for me to recommend it.

First, let me explain who the authors are. Lester Levenson was a man who was told at the age of 42 that he was going to die. Instead, Levenson decided to work on himself. He found a way of letting go of all of his inner limitations and used it extensively on himself for a period of three months. At the end of that time period, his body was totally healthy and he entered a period of prolonged peace that he never again left until he died nearly 40 years later. Levenson is actually the founder of the Sedona Method Course® but I like this series of books better.

Hale Dwoskin is the person who currently runs Levenson's old organization. I've never met him, but I've seen him on video (and you get the DVD if you buy this book set), and this man seems to be in a constant state of joy and lightness.

So who better to get a book series on happiness from than these two?

Each book has seven chapters and your assignment is to spend a week on each chapter, either rereading it or doing the exercises.

For example, here is the first exercise in the book:

> First, make a list of persons, places, things, and/or accomplishments that you think will make you happy. For example, you might write down such things as:
>
> - I'll be happy if I make a million dollars trading in the next year.
> - I'll be happy when I marry the perfect woman/man.
> - If my spouse would just do this, I'd be happy.
>
> And then the exercise you are to do with your list is to ask yourself, as you review each item on the list, "Could I let go of wanting to get happiness from (this item) and allow myself to rest in the happiness that I already have?"

The releasing exercise is quite simple, and even if you don't understand it at first, it's readily explained in the video that comes with the book introducing the Sedona method.

During the first week, I found myself making up other exercises that related to the first one and the whole experience was quite powerful. Each book has seven chapters—so you spend seven weeks on each book. And since there are five books, that means that this is a 35 week course.

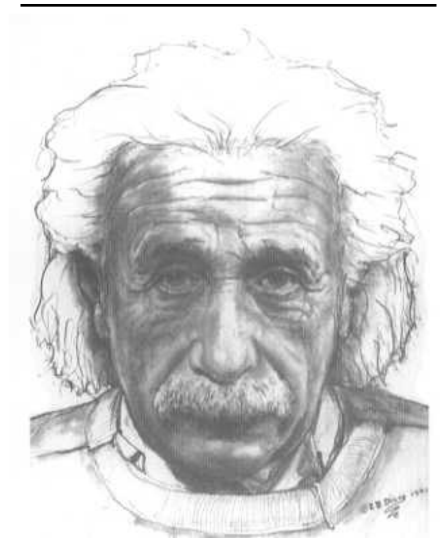
If you want to try it, the first book is available at Amazon.com, and it's under $10.

2) *Strategies of Genius, Volume Two: Einstein* by Robert Dilts

People are always asking me which NLP books I like. And my answer is usually anything by Robert Dilts. Dilts has been the master of writing down the essence of NLP. I love the whole *Strategies of Genius* series, but *Volume Two on Einstein* is my absolute favorite. Both Volumes One and Two are available from us, but Volume Three is out of print.

What I particularly like about this process is that Dilts takes you through Einstein's thinking process. And it's not about complex mathematics or physics. Instead, it's all about imagination. And guess what? When I went through this process, the idea of relativity was perfectly clear to me. It's actually easy to understand. It's only the mathematical expressions of it that can be difficult.

What was interesting to me was that Einstein, for some reason, decided to



hold the speed of light as a constant. However, there are other aspects of the same equation that you could hold constant—and I did that in the exercises—and the implications were totally different.

Anyway, if you want to learn how a genius thought and want to think that way yourself, then I strongly recommend you read this book.

3) *Changing Belief Systems with NLP* by Robert Dilts

If you really want to understand how you think and what shapes your reality, then I believe this book is a must read. Let me give you a story from the book in which Dilts makes a point about beliefs.

> There is a classic story of a mental patient who believes he is a corpse. He won't do anything including eat, because he thinks he is a corpse.
>
> The psychiatrist who is working with him asks him, "Do corpses bleed."
>
> The man replied, "No, all body functions have stopped, so there is no more bleeding."
>
> So the psychiatrist took a needle and pricked his finger, drawing some blood. The patient looked at his finger in amazement and said, "I'll be damned, corpses do bleed." And upon thinking about it, the psychiatrist had already proven that corpses talk as well.

The point about this story is that environmental and behavioral evidence won't necessarily change a belief because a belief isn't a reality. Instead, beliefs are your substitute for reality. They are your filters to reality.

With that in mind, Dilts goes into the fascinating subject of beliefs and how to change them.

I took a course from Robert once and at that course I met his mother. The interesting thing about Robert's mother is that she was once pronounced with terminal cancer. Robert immediately went into working with her for days on end to change her beliefs about herself and her illness. And when I met her, she had had no signs of cancer for many years. And, interestingly enough, Robert says that the likelihood of a cure from any illness depends, not upon the cure, but upon the patient's belief that the cure will work.

This very fascinating book, and I strongly recommend it.

4) *Living Deliberately: The Discovery and Development of Avatar* by Harry Palmer

Two of the books I'm going to recommend are core books from people who have started teaching programs that lead to massive self-improvement. The first was the happiness book series, and the second is by the founder of Avatar.

I'm also biased here because I've taken the Avatar Course, the Avatar Masters Course, and the Avatar Wizard's Course. And I've taken the basic course and the wizard course twice.

Living Deliberately tells the story of Harry Palmer's adventures with a flotation tank. It tells the story of how we, at least through Palmer's version of it, create our own experience and ultimately the universe. But most importantly, it tells the story of how we can escape from our self-imposed limitations.

Here are a few examples of some of the ideas that Harry comes up with in the book:

- The self is an idea that awareness is temporarily availing itself for the purpose of experiencing certain other ideas. The self is a means of participating in a paradigm. It is possible to change self or even to go beyond self altogether.
- When you adopt the viewpoint that there is nothing that exists that is not part of you, that there is no one who exists who is not part of you, that any judgment you make is self-judgment, that any criticism you level is self-criticism, you will wisely extend to yourself an unconditional love that will be the light of your world.
- Pretending is imagination without faith. Creation is imagination with faith. People who believe in their pretenses create them for real.
- Fear is a BELIEF in our inadequacy to deal with something. And that belief precedes any evidence of failure we have collected!
- We create possibility by believing ourselves into it, and we dissolve limitation by experiencing ourselves out of it.

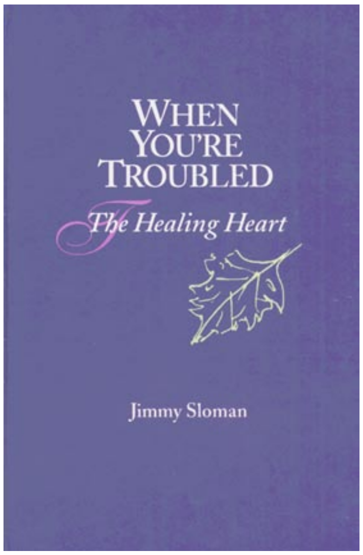
This book also has one of my favorite quotes of all time: "We experience what we believe, unless we believe we won't, in which case we don't, which means we did."

The examples and quote might sound a bit cryptic, but they do give you a flavor for the book and this book is quite easy to read. I recommend it strongly, so strongly that we actually have about 20 copies of it in stock.

5) *When You're Troubled: The Healing Heart* by Jimmy Sloman

I loved this book. In fact, I paid the author $2,000 a month for two years while he was writing this book. And my reward was that the first edition of the book was dedicated to me.

However, there have been many revisions of the book and it has subsequently gone through several title changes. I'm biased enough to like the first version the best.



And the new versions no longer have the dedication. You'll understand why as you read my review.

The book is divided up into eight chapters. The first section has to do with the spirit with a chapter on the inner soul and then another on the outer manifestations of it. The next section has to inner mind and it is followed by another chapter about the outer mind. The third section has to do with inner heart and then the outer heart. And the last section has to do with the inner and outer body.

This book is about waking up. It starts out explaining how to meditate, how to deal with your thoughts and feelings as they come up, but just generally how to quiet your mind. I did several workshops with Sloman and we went through the process that he teaches in detail. It's simple mindfulness and the process is wonderful.

The next section has to do with letting go and trusting. In fact, its subtitle is "letting go of the outcome." And one of the secrets to manifesting what you want in life is to put it out into the universe and then let go of the outcome.

I'm not going to try to describe each section because I could never do justice to what is in this book. However, I can tell you that this book is loaded with techniques that are designed to lift you and help you feel better about yourself. That's it's purpose.

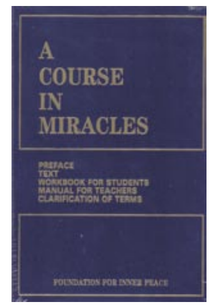
In fact, when the book first came out, people tended to describe it as a life saver. It's the sort of book that people tend to say, "Why didn't this book come into my life sooner?" It's that good.

I recommend this book with some trepidation. The book itself stands on its own and it's an incredible book. However, I used to have a strong relationship with the author. I felt an incredible bond with him as do most people who come into his presence. There is something magical about Jimmy Sloman and I believe its because he is always totally there with you. He is totally present with you. And few people have that quality. But remember I gave him nearly $50,000. I remember once sitting at a dinner table with six or seven of my best clients. And guess what? All of them had given money to Jimmy. In every case, it was borrowed money, but none of these people to my knowledge has ever been paid back. Perhaps at a spiritual level its all about giving anyway. What you give, at some level, you give to yourself. However, at that point, I also made the decision to avoid exposing my clients to him, even though I liked his books immensely. So just remember on this one, *I'm recommending the book, not the author*. You can order this book through our website.

Spiritual Books

My last category is the area of spiritual books. There is a fine line between the books I've recommended as psychological and those I've recommended as spiritual. In fact, I think that good spiritual books are also great self-improvement books. Perhaps the main difference is that the spiritual books have a little broader scope.

1) *A Course In Miracles (ACIM)*. by Anonymous



This will probably be my top book of all time because it has literally changed my life. The author is listed as Anonymous but it was channeled through a Jewish psychologist (Helen Schucman) at Columbia University by Jesus. Three books were channeled over a seven year period. These are the Textbook, The Workbook for Students, and the Manual for Teachers. And you don't have to believe the real author is Jesus to benefit greatly from ACIM.

What I recommend is that you start working on the Workbook. This consists of 365 daily lessons. You don't have to believe the lessons—just do them. To me, they are among the most sophisticated psychology/meditation exercises I have ever come across.

Here is my challenge to you: Get the book (we carry it at IITM) and do the first 90 lessons in the Workbook. If by that time, you haven't seen some profound changes in your life (for the better), then perhaps this is not the path for you.

I started doing ACIM in 1985. It took me four years to complete the

365 daily exercises. Sometimes I'd just want to throw the book away and hope I'd never see it again. However, it would usually find its way back into my life within a month or two. Sometimes I'd feel incomplete on an exercise and would repeat it for several days. However, when I finished doing ACIM, I had moved from being a research psychologist to having a full-time business helping traders transform themselves. And over the years, that business has run into many roadblocks, which would normally result in a failure, but somehow we have survived.

After 1989, I stopped doing ACIM. I did other things instead such as private consulting with a former Scientology Practitioner, lots of NLP training at various workshops, Life Spring, Avatar all the way through the Wizard's course, and most recently the Sedona Method. However, this year I have returned to my roots and am again doing ACIM. I'm about half way through the course and the year is 2/3rds over with—so I seem to be progressing a little faster than before. Also, two of my staff members (quite independent of me) are also working through ACIM, which I find interesting.

Anyway, it's impossible to really do justice to ACIM in a few words, so I'll just leave you with two phrases from ACIM. The first is basically at the beginning of ACIM and it says:

> "This is a course in miracles. It is a required course. Only the time you take it is voluntary."

The course teaches us that there is no time and that we do not die, so that makes the initial statement a little bit more understandable.

Finally, the last part of the first page, summarizes the teaching very well.

> Nothing real can be threatened.
>
> Nothing unreal exists.
>
> Herein lies the peace of God.

The first time I went through the course, those lines didn't mean much to me. However, this time, I find myself going back to those lines over and over again.

Even though it has nothing to do with trading, IITM keeps a few copies of *A Course In Miracles* in stock.

2) *The Disappearance of the Universe* by Gary R. Renard

One of the interesting things that happens to me is that my clients send me book suggestions, knowing my interests. This was one such book that came my way this year. I was told it was must read.

The subtitle of the book says, "Straight talk about Illusions, Past Lives, Religion, Sex, Politics, and the Miracle of Forgiveness." And the book talks about Renard's personal experience over the period from 1992 to 2002 when two mysterious people suddenly materialized in his living room and started talking to him about these things. By the way, if you can't relate to two people suddenly materializing in front of him, you might be able to relate to Renard being a full time, private investor/trader when these adventures started.

Anyway, what fascinated me about this book was that it was a book suggesting that people do A Course In Miracles. Wow, isn't it interesting that such a book would come my way when I started doing ACIM for the second time?

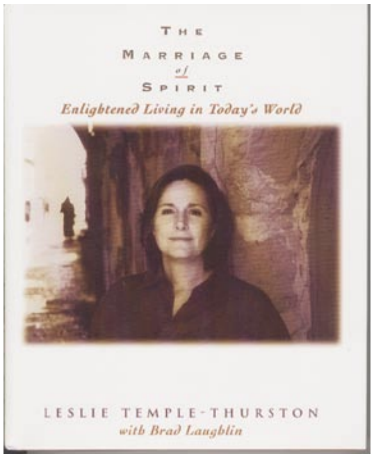
The first time I did ACIM, I did all 365 exercises. I read every bit of the Text and even got to the point when I thought I understood it. I also found Marianne Williamson before she became famous. She was lecturing on ACIM in Hollywood during the time I was doing ACIM. I attended one of her lectures on ACIM every week for almost a year. And I often taped the lecture and listened to it again.

Now, here is what is interesting. When I read *The Disappearance of the Universe*, I said, "Wow, I don't remember ACIM saying THAT at all." But as I started getting into the material in more depth, having read Renard's book, I discovered that it *was* what ACIM was saying.

And to me that's the beauty of ACIM. You tend to get out of it what you are ready for at the time. In the mid 1980s, I was struggling with the issues of personal responsibility and self-sabotage, and grasping to understand those. I wasn't ready for the insights I am getting now.

However, there is nothing complex about reading the *Disappearance of the Universe*. It's easy to understand. So if you are thinking about ACIM but are totally new to it, then I suggest you read this book first.

By the way, miracles sometimes work. I had never heard of Gary Renard. After I restarted ACIM, a client referred me to this book and I read it. About two weeks later, I discovered that Renard was going to be giving a one-day workshop in Raleigh. I went to the workshop with one of my staff members and found it very insightful. And that was Renard's first time speaking in Raleigh. Hmm!!



3) *The Marriage of Spirit: Enlightened Living in Today's World* by Leslie Temple-Thurston

I could have listed this one as a psychological book. It's at about the same level as the *Happiness* book series or Harry Palmer's book. The author's story is pretty similar. Leslie, through studying with a mentor, achieved a degree of enlightenment, and through that enlightenment, wrote this book about how to live in today's world and move toward enlightenment.

Part One give a general introduction to our state of existence. The overall message is pretty much the same in all of these books. And I don't want to get into that message in much detail here. But all of these books essentially say that WE ARE ALL ONE. It is only the idea that we are separate that keeps us from realizing that. The idea that we are separate from everything basically sets us up to totally limit ourselves.

Another key that good spiritual books tend to have in common is the notion that "what we see out there is a reflection of what is going on in our minds." It's not really "out there" though, because we have been creating it. For example, one of my goals in the Peak Performance Course is to teach you that what you experience in the market, isn't coming from the market. It's coming from you. It comes from your beliefs. It comes from your emotions, all of which are inside of you. And I found that it is quite amazing how well people can begin to trade when you realize these things and start working on them.

Okay, so Part One of this book gives you more theory along those lines. Part Two of the *Marriage of Spirit* book is full of techniques that you can use to bring yourself back to wholeness. Leslie has exercises on

1) Polarities;

2) Triangles; and

3) Squares,

plus several chapters on how to use these exercises in your daily life.

So let's briefly talk about the polarities exercise, which is a seven-step process.

Step One: Pick an experience that has bothered you. It might be a current experience or a very old experience.

Step Two: Write about the experience. Write a long story describing the experience and just say everything.

Step Three: Go through your written story and pick out all the theme words and phrases. It might be words like victim, anger, helpless, being right, etc. Leslie gives several good examples of stories with the highlighted phrases.

Step Four: Make a list of the theme words and phrases on a sheet of paper. When you finish, read through your list and the mere act of reading it might remind you of more words or phrases that are common to your life and should be there (shouldn't be there?).

Step Five: Find the opposites. For example, if one of the phrases is "cause an accident," you might decide that the opposite is "drive safely." If another word is "anger," you might decide that the opposite is "peace." So make a list with your theme words on one side and the opposite word on the other side.

Step Six: Offer your list up with a prayer. When you feel like you've put it all out there, then ask your higher consciousness to take these pairs of opposites and bring them into balance for you.

Step Seven: Wait for a shift. This might not occur immediately and when it does occur, it might take on several forms. One form is a shift in how you feel. Another form is a sudden flood of insights. Just remember that there is nothing to do here, but offer it to your Higher Self or to Spirit or to God—however, you prefer to phrase it.

This last part of this exercise is not too dissimilar to the forgiveness exercises in ACIM.

Anyway, I really like this book, so we also carry it at IITM.

4) *Power versus Force;*

5) The Eye of the I; and *I* by David Hawkins

As my last recommendation, I'm really recommending three books. Hawkins is another enlightened man that I greatly admire. What you will learn in this series of books can really help to explain this complex world that we seem to live in.

Hawkins claims that you can calibrate human consciousness on a logarithmic scale that goes from one to 1000. One thousand is the level of the great masters such as Jesus, Buddha, Krishna, etc. And about 200 is the level at which human beings start to progress and evolve, rather than kill each other.

For much of the last 2000 years, human consciousness has been just below the 200 level. But in 1987 it suddenly shifted to slightly above 200 and it recently shifted to above 210. And I think I've certainly noticed the shift. When I first started this business, I could never have written about the books I like best. It would have offended too many people. But in today's climate most of my best clients want this sort of information. That's a huge shift.

What you'll learn from these three books is Hawkin's own story of his personal evolution, plus a detailed idea about what consciousness is like at various realms.

First, a little bit about Hawkins. By the time he became a full-fledged psychiatrist, he was quite enlightened. He tells the story of seeing patients and just going inside them and connecting with them at a spiritual level and they would become normal (or at least much more at peace). Because of his "special" abilities, he soon had the largest psychiatric practice in the United States.

However, Hawkins then went through another transformation and it was clear to him that he needed to do something else. He spent a number of years in solitude and peace and then came out and developed kinesthesia testing as a means of measuring human consciousness. It was actually a Ph.D. thesis. And, of course, his work is very controversial. All you need to do is look at some of the reviews on his books on Amazon to see what many academics think of it.

However, I always look at this material with the idea of "is it useful?" And I think Hawkins' work is very useful. Carol Adams, Ph.D. and I went to hear him speak in San Diego and we both had an inner sense that Hawkins was legitimate. And my training has taught me that I can only really trust that "inner sense."

Power versus Force makes many points. Here are a couple of the most interesting:

1) There is a "yes/no" answer to any question asked not concerning the future, this is done by kinesiological testing, which is a branch of science that links the mind and the body to see how one reacts with changes in the other.

2) Hawkins believes that enlightenment starts at 600 on his scale of consciousness which is the level of unconditional love. However, I find it interesting to suggest that when one reaches "unconditional love" there is a long way to go.

The final conclusion of the book is that power ultimately always defeats force. It states that the higher states of consciousness can only be reached by getting close to the energy attractors created by power instead of force and that lower levels exist because they get close to force energy attractors. A good example of this is Gandhi, who—calibrated at 700—was capable of driving the British army (calibrated at about 190) single handedly out of India without any violence.

The Eye of the I: From Which Nothing is Hidden is Hawkins' second book in the trilogy. I found this book to be a fascinating read, but I must also admit that after six months, I cannot remember a lot of the content. I only remember that a lot of my questions about "reality" seemed to be answered by this book. However, it is such that probably even after I had just finished it, I would have still had trouble succinctly telling you what it was about.

The last book, simply entitled *I*, is the best book of the series. When I finished reading it, I felt as if I had just read a masterpiece. The book was generally about the levels of consciousness above 600—giving us a glimpse of what may be in store for us one of these days and what it takes to get there. It was difficult to read, but I found that it made a lot of sense to me. However, just like the last book at the end of reading it, I'm hard pressed to tell you exactly what was inside. And perhaps that's because the contents are so enormous.

However, if you are a spiritual seeker, then I strongly recommend all three books by Hawkins. Hawkins now has a fourth book titled *Truth versus Falsehood*. I have not read this book yet, but I can see from the reviews that you either love this one or totally hate it.

A Reminder:

Two Systems are Required to Trade

By

Van K. Tharp, Ph.D.

If you read last quarter's *Market Mastery* and understood it, then you should really begin to understand that it takes two systems to trade the markets. And it just begins to show how sophisticated top traders are becoming.

The first system you need is your trading system. This consists of your setups, entries, filters, stops, and profit taking exits. The net result of such a system is a set of R-multiple distributions. And you measure the quality of this system by its expectancy (mean R), the amount of trading opportunity it gives you (which we sometimes call expectancy times opportunity or expectunity), and the system quality number, which was discussed extensively in the last issue.

If you have three systems, with system quality numbers of 1.14, 1.75, and 2.54, then you'll probably find that the first system is very difficult to trade. The second system is tradable, but requires that you maintain a very strict discipline, while the third system is a super dynamo.

The second system you need is your position sizing system. This is the part of your trading that tells you how much to trade. And this is the part of your trading methodology that HELPS YOU ACHIEVE YOUR OBJECTIVES. Unfortunately, most people ignore this part.

Why?

Most people don't have objectives. They think they do, but they really don't. They just have a vague concept in their heads of "I want to make a lot of money." Yet, objectives are 50% of designing a system that fits you.

Furthermore, there are probably as many possible objectives for trading as there are systems. For example, you could have any of the following goals:

"Most people don't have objectives. They think they do, but they really don't."

- V. Tharp

- A goal to maximize your probability of increasing your equity by X percent in the market, and since X percent could be any number this could translate into a large number of objectives.
- A goal to minimize your probability of ruin (being down Y percent), which is the point at which you'd stop trading. And even Y could range from down 1% to down 100%.
- You could have a goal to get the maximum yield (usually the median average ending equity) out of your system.
- Or you could have a goal to simultaneously get the highest probability of increasing your equity by X percent and the lowest probability of aY percent drawdown.

And all of these are different objectives. And guess what, they would all require that you use a different position sizing algorithm.

Now this gets me to another key point. How do you know what position sizing algorithm to use? Well you could guesstimate based upon the quality of your system. For example, we generally recommend that you start trading very small—using ½% risk or less. And we usually recommend that you not risk more than 1% unless you have a great system or lots of profits that you are willing to give back.

Or the other thing that you could do would be to use a simulator on your R-multiple distribution to estimate your position-sizing more accurately. But that is another story.

My point in writing this is that when I first entered the business of coaching traders most people thought that a trading system was an indicator. Few people had really good systems and one of my jobs was to teach them what was involved in a complete system.

And, even today, that has not changed. Position sizing (and psychology) account for 90% of the variability of your performance and you cannot neglect them.