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Interviews with
TOP TRADERS

JACK D. SCHWAGER

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Market Wizards

Interviews with Top Traders

Jack D. Schwager



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*To my wife Jo Ann
and my children
Daniel, Zachary, and Samantha
for the love they give
and, more important,
the love they receive.*

You've got to learn how to fall, before you learn to fly.

—*Paul Simon*

One man's ceiling is another man's floor.

—*Paul Simon*

If I wanted to become a tramp, I would seek information and advice from the most successful tramp I could find. If I wanted to become a failure, I would seek advice from men who had never succeeded. If I wanted to succeed in all things, I would look around me for those who are succeeding and do as they have done.

—*Joseph Marshall Wade,*
as quoted in Treasury of Wall Street Wisdom,
edited by Harry D. Schultz and Samson Coslow

Contents

Preface to the Paperback Edition	ix
Preface	xv
Acknowledgments	xvii
Prologue	xix
My Own Story	xxi

Part I Futures and Currencies	1
--------------------------------------	----------

Taking the Mystery Out of Futures	3
The Interbank Currency Market Defined	7
Michael Marcus: Blighting Never Strikes Twice	9
Bruce Kovner: The World Trader	51
Richard Dennis: A Legend Retires	83
Paul Tudor Jones: The Art of Aggressive Trading	115
Gary Bielfeldt: Yes, They Do Trade T-Bonds in Peoria	139
Ed Seykota: Everybody Gets What They Want	151
Larry Hite: Respecting Risk	175

Part II Mostly Stocks	193
Michael Steinhardt: The Concept of Variant Perception	195
William O'Neil: The Art of Stock Selection	221
David Ryan: Stock Investment as a Treasure Hunt	239
Marty Schwartz: Champion Trader	257
Part III A Little Bit of Everything	281
James B. Rogers, Jr.: Buying Value and Selling Hysteria	283
Mark Weinstein: High-Percentage Trader	321
Part IV The View from the Floor	343
Brian Gelber: Broker Turned Trader	345
Tom Baldwin: The Fearless Pit Trader	367
Tony Saliba: "One-Lot" Triumphs	385
Part V The Psychology of Trading	405
Dr. Van K. Tharp: The Psychology of Trading	407
The Trade: A Personal Experience	429
Postscript: Dreams and Trading	435
Final Word	439
What I Believe 22 Years Later	441
Appendix 1: Program Trading and Portfolio Insurance	453
Appendix 2: Options—Understanding the Basics	455
Glossary	461
Excerpt: Edward Thorp	473

Preface to the Paperback Edition

The most basic investment question is: Can the markets be beat? The efficient market hypothesis provides an unambiguous answer: No, unless you count those who are lucky.

The efficient market hypothesis, a theory explaining how market prices are determined and the implications of the process, has been the foundation of much of the academic research on markets and investing during the past half century. The theory underlies virtually every important aspect of investing, including risk measurement, portfolio optimization, index investing, and option pricing. The efficient market hypothesis can be summarized as follows:

- Prices of traded assets already reflect all known information.
- Asset prices instantly change to reflect new information.
- Therefore,
 - Market prices are perfect.
 - It is impossible to consistently outperform the market by using any information that the market already knows.

The efficient market hypothesis comes in three basic flavors:

1. *Weak efficiency*. This form of the efficient market hypothesis states that past market price data cannot be used to beat the market. Translation: Technical analysis is a waste of time.
2. *Semi-strong efficiency* (presumably named by a politician). This form of the efficient market hypothesis contends that you can't beat the market using any publicly available information. Translation: Fundamental analysis is also a waste of time.
3. *Strong efficiency*. This form of efficient market hypothesis argues that even private information can't be used to beat the market. Translation: The enforcement of insider trading rules is a waste of time.

Corollary: The readers of this book are delusional.

The efficient market hypothesis assumes the markets can't be beat because everyone has the same information. This reasoning is conceptually flawed. Even if everyone had all the same information, there's no reason to assume they would reach the same decision as to the appropriate price of a market or security. For example, in a chess tournament, all the players know the same rules and have access to the same chess books and records of past games by world champions, yet only a small minority excel. There is no reason to assume that all the players will use the same information with equal effectiveness. Why should the markets, which in a sense represent an even more complex game than chess (there are more variables and the rules are always changing) be any different?

In a chess tournament, a few highly skilled players will win most of the games by exploiting the mistakes of weaker players. Much like chess, it seems only reasonable to expect a few highly skilled market participants to interpret the same information—the current position of the market chessboard, so to speak—differently from the majority, and reach variant conclusions about the probable market direction. In this conceptual framework, mistakes by a majority of less skilled market participants can drive prices to incorrect levels (i.e., prices out of line with the unknown equilibrium level), creating opportunities for more skilled traders.

Efficient market hypothesis proponents are absolutely correct in contending that markets are very difficult to beat, but they are right

for the wrong reason. The difficulty in gaining an edge in the markets is not because prices instantaneously discount all known information (although they *sometimes* do), but rather because the impact of emotion on prices varies greatly and is nearly impossible to gauge. Sometimes emotions will cause prices to wildly overshoot any reasonable definition of fair value—we call these periods market bubbles. At other times, emotions will cause prices to plunge far below any reasonable definition of fair value—we call these periods market panics. Finally, in perhaps the majority of the time, emotions will exert a limited distortional impact on prices—market environments in which the efficient market hypothesis provides a reasonable approximation. So either market prices are not significantly out of line with fair valuations (muted influence of emotions on price) or we are faced with the difficult task of determining how far the price deviation may extend.

Although it is often possible to identify *when* the market is in a euphoric or panic state, it is the difficulty in assessing *how far* bubbles and panics will carry that makes it so hard to beat the market. One can be absolutely correct in assessing a fair value for a market, but lose heavily by taking a position too early. For example, consider a trader who in late 1999 decided the upward acceleration in technology stocks was overdone and went short the NASDAQ index as it hit the 3,000 mark. Although this assessment would have been absolutely correct in terms of where the market traded in the decade beginning the year after the bubble burst (1,100 to 2,900 range), our astute trader would likely have gone broke as the market soared an additional 68 percent before peaking at 5,048 in March 2000. The trader's market call would have been fundamentally correct and only four months off in picking the top of a 10-year-plus bull market, yet the trade would still have been a disaster. There is certainly no need to resort to the assumption of market perfection to explain why winning in the markets is difficult.

The acknowledgment that emotions can exert a strong, and even dominant, influence on price has critical implications. According to this view of market behavior, markets will still be difficult to beat (because of the variability and unpredictability of emotions as a market factor) but, importantly, not impossible to beat. In fact, the impact of

emotions causing prices to move far out of line with true valuations will itself create investing and trading opportunities.

Supporters of the efficient market hypothesis are reluctant to give up the theory, despite mounting contradictory evidence, because it provides the foundation for a broad range of critical financial applications, including risk assessment, optimal portfolio allocation, and option pricing. The unfortunate fact, however, is that these applications can lead to erroneous conclusions because the underlying assumptions are incorrect. Moreover, the errors will be most extreme in those periods when the cost of errors will be most severe (i.e., market bubbles and panics). In some sense, efficient market hypothesis proponents are like the proverbial man looking for dropped car keys in the parking lot under the lamppost because that is where the light is.

The flaws of the efficient market hypothesis are both serious and numerous:

- If true, the impossible has happened—and many times. To cite only one example, on October 19, 1987, S&P futures fell by an astounding 29 percent! If the efficient market hypothesis were correct, the probability of such an event occurring would be 10^{-160} —a probability that is so impossibly remote that it is roughly equivalent to the odds of randomly picking a specific atom in the universe and then randomly picking the same atom in a second trial. (This calculation is based on the estimate of 10^{80} atoms in the universe. Source: www.wolframalpha.com.)
- Some market participants (including some in this book) have achieved track records that would be a statistical impossibility if the efficient market hypothesis were true.
- The assumed mechanism for prices adjusting to correct levels is based on a flawed premise, since the price impact of informed traders can be outweighed temporarily by the actions of less knowledgeable traders or by the activity of hedgers and governments, which are motivated by factors other than profit.
- Market prices completely out of line with any plausible valuations are a common occurrence.
- Price moves often occur well after the fundamental news is well known.

- Everyone having the same information does not imply that everyone will use information with equal efficiency.
- The efficient market hypothesis fails to incorporate the impact of human emotions on prices, thereby leaving out a key market price influence that throughout history has at times (e.g., market bubbles and crashes) dominated the influence of fundamental factors.

The bad news is: The efficient market hypothesis would preclude the possibility of beating the market other than by chance. The good news is: The efficient market hypothesis appears to be deeply flawed on both theoretical and empirical grounds. So to answer the question at the start of this section, yes, the markets can be beat, although doing so is very difficult.

I am frequently asked whether becoming a Market Wizard is a matter of innate talent or hard work. My standard answer is to use a running analogy. As intimidating as the task may seem to those physically unconditioned, most people can run a marathon given sufficient training and dedication. But only the small minority born with the right physical characteristics will ever be able to run a 2:15 (men) or 2:30 (women) time, regardless of how hard they work. The analogy for trading is that, similar to running a marathon, proficiency is achievable with hard work, but performing at an elite level requires some degree of innate talent. The level of trading success attained by many of the Market Wizards is possible only because they have some innate skill, or some inner radar, that gives them a better-than-even probability of sensing what markets will do. I don't care how devoted someone is to trading or how many hours they are willing to watch trading screens; the reality is that this type of skill will be out of reach for most people.

Preface

There are some amazing stories here:

- A trader who, after wiping out several times early in his career, turned a \$30,000 account into \$80 million
- A fund manager who achieved what many thought impossible—five consecutive years of triple-digit percentage returns
- A trader from small-town America who started out on a shoestring and has become one of the world's largest bond traders
- A former securities analyst who, during the past seven years, has realized an average *monthly* return of 25 percent (over 1,400 percent annualized), primarily trading stock index futures
- An electrical engineering graduate from MIT whose largely computerized approach to trading has earned his accounts an astounding 250,000 percent return over a sixteen-year period

These are but a sampling of the interviews contained in this book. In his own way, each of the traders interviewed has achieved incredible success.

What sets these traders apart? Most people think that winning in the markets has something to do with finding the secret formula.

The truth is that any common denominator among the traders I interviewed had more to do with attitude than approach. Some of the traders use fundamental analysis exclusively, others employ only technical analysis, and still others combine the two. Some traders operate on a time horizon measured in hours or even minutes, while others typically implement positions that they intend to hold for months or even years. Although the trading methodologies varied widely, the forthcoming interviews reveal certain important commonalities in trading attitudes and principles.

Trading provides one of the last great frontiers of opportunity in our economy. It is one of the very few ways in which an individual can start with a relatively small bankroll and actually become a multimillionaire. Of course, only a handful of individuals (such as those interviewed here) succeed in turning this feat, but at least the opportunity exists.

While I hardly expect all readers of this book to transform themselves into super-traders—the world just doesn't work that way—I believe that these thought-provoking interviews will help most serious and open-minded readers improve their personal trading performance. It may even help a select few become super-traders.

Jack D. Schwager
Goldens Bridge, NY
May 1989

Acknowledgments

First and foremost, I would like to thank Stephen Chronowitz, who pored over every chapter in this book and provided a multitude of helpful suggestions and editing changes. I am indebted to Steve for both the quantity (hours) and quality of his input. I truly believe that whatever the merits of this work, it has benefited significantly from his contributions.

I am grateful to my wife, Jo Ann, not only for enduring nine months as a “book widow,” but also for being a valuable sounding board—a role she performed with brutal honesty. Sample: “This is the worst thing you ever wrote!” (Needless to say, that item was excised from the book.) Jo Ann possesses common sense in abundance, and I usually followed her advice unquestioningly.

Of course, I would like to express my thanks to all the traders who agreed to be interviewed, without whom there would be no book. By and large, these traders neither need nor seek publicity, as they trade only for their own accounts or are already managing all the money they wish to. In many cases, their motives for participating were altruistic. For example, as one trader expressed it, “When I was starting out,

I found biographies and interviews of successful traders particularly helpful, and I would like to play a similar role in helping new traders.”

I wish to express my sincere appreciation to Elaine Crocker for her friendly persuasion, which made some of the chapters in this book possible. For advice, leads, and other assorted favors, I would like to thank Courtney Smith, Norm Zadeh, Susan Abbott, Bruce Babcock, Martin Presler, Chuck Carlson, Leigh Stevens, Brian Gelber, Michael Marcus, and William Rafter. Finally, I would like to thank three traders who were gracious enough to grant me lengthy interviews, which were not incorporated into this book: Irv Kessler, Doug Redmond, and Martin Presler (the former two because, in retrospect, I considered my line of questioning too esoteric and technical; the latter because publication deadlines did not permit time for needed follow-up interviews and editing).

Prologue

The name of the book was *The Big Board*. . . . It was about an Earth-ling man and woman who were kidnapped by extraterrestrials. They were put on display in a zoo on a planet called Zircon-212.

These fictitious people in the zoo had a big board supposedly showing stock market quotations and commodity prices along one wall of their habitat, and a news ticker, and a telephone that was supposedly connected to a brokerage on Earth. The creatures on Zircon-212 told their captives that they had invested a million dollars for them back on Earth, and that it was up to the captives to manage it so that they would be fabulously wealthy when they were returned to Earth.

The telephone and the big board and the ticker were all fakes, of course. They were simply stimulants to make the Earthlings perform vividly for the crowds at the zoo—to make them jump up and down and cheer, or gloat, or sulk, or tear their hair, to be scared shitless or to feel as contented as babies in their mothers' arms.

The Earthlings did very well on paper. That was part of the rigging, of course. And religion got mixed up in it, too. The news ticker reminded them that the President of the United States had declared

National Prayer Week, and that everybody should pray. The Earthlings had had a bad week on the market before that. They had lost a small fortune in olive oil futures. So they gave praying a whirl. It worked. Olive oil went up.

—Kurt Vonnegut Jr.
Slaughterhouse Five

If the random walk theorists are correct, then Earthbound traders are suffering from the same delusions as the zoo inhabitants of Kilgore Trout's novel. (Kilgore Trout is the ubiquitous science fiction writer in Kurt Vonnegut's novels.) Whereas the prisoners on Zircon-212 thought their decisions were being based on actual price quotes—they were not—real-life traders believe they can beat the market by their acumen or skill. If markets are truly efficient and random in every time span, then these traders are attributing their success or failure to their own skills or shortcomings, when in reality it is all a matter of luck.

After interviewing the traders for this book, it is hard to believe this view of the world. One comes away with a strong belief that it is highly unlikely that some traders can win with such consistency over vast numbers of trades and many years. Of course, given enough traders, some will come out ahead even after a long period of time, simply as a consequence of the laws of probability. I leave it for the mathematicians to determine the odds of traders winning by the magnitude and duration that those interviewed here have. Incidentally, the traders themselves have not a glimmer of doubt that, over the long run, the question of who wins and who loses is determined by skill, not luck. I, too, share this conviction.

My Own Story

Right out of graduate school, I landed a job as a commodity research analyst. I was pleasantly surprised to find that my economic and statistical analysis correctly predicted a number of major commodity price moves. It was not long thereafter that the thought of trading came to mind. The only problem was that my department generally did not permit analysts to trade. I discussed my frustration over this situation with Michael Marcus (first interview), with whom I became friends while interviewing for the research position he was vacating. Michael said, “You know, I had the same problem when I worked there. You should do what I did—open an account at another firm.” He introduced me to a broker at his new firm, who was willing to open the account.

At the time, I was earning less than the department secretary, so I didn’t exactly have much risk capital. I had my brother open a \$2,000 account for which I acted as an advisor. Since the account had to be kept secret, I could not call in any orders from my desk. Every time I wanted to initiate or liquidate a position, I had to take the elevator to the building’s basement to use the public phone. (Marcus’ solution to the same problem is discussed in his interview.) The worst part of the situation was

not merely the delays in order entry, which were often nerve-wracking, but the fact that I had to be very circumspect about the number of times I left my desk. Sometimes, I would decide to delay an order until the following morning in order to avoid creating any suspicion.

I don't remember any specifics about my first few trades. All I recall is that, on balance, I did only a little better than break even after paying commissions. Then came the first trade that made a lasting impression. I had done a very detailed analysis of the cotton market throughout the entire post-World War II period. I discovered that because of a variety of government support programs, only two seasons since 1953 could truly be termed *free markets* [markets in which prices were determined by supply and demand rather than the prevailing government program]. I correctly concluded that only these two seasons could be used in forecasting prices. Unfortunately, I failed to reach the more significant conclusion that existing data were insufficient to permit a meaningful market analysis. Based on a comparison with these two seasons, I inferred that cotton prices, which were then trading at 25 cents per pound, would move higher, but peak around 32–33 cents.

The initial part of the forecast proved correct as cotton prices edged higher over a period of months. Then the advance accelerated and cotton jumped from 28 to 31 cents in a single week. This latest rally was attributed to some news I considered rather unimportant. "Close enough to my projected top," I thought, and I decided to go short. Thereafter, the market moved slightly higher and then quickly broke back to the 29-cent level. This seemed perfectly natural to me, as I expected markets to conform to my analysis. My profits and elation were short-lived, however, as cotton prices soon rebounded to new highs and then moved unrelentingly higher: 32 cents, 33 cents, 34 cents, 35 cents. Finally, with my account equity wiped out, I was forced to liquidate the position. Not having much money in those days may have been one of my luckiest breaks, since cotton eventually soared to an incredible level of 99 cents—more than double the century's previous high price!

That trade knocked me out of the box for a while. Over the next few years, I again tried my hand at trading a couple of times. In each instance, I started with not much more than \$2,000 and eventually

wiped out because of a single large loss. My only consolation was that the amounts I lost were relatively small.

Two things finally broke this pattern of failure. First, I met Steve Chronowitz. At the time, I was the commodity research director at Homblower & Weeks, and I hired Steve to fill a slot as the department's precious metals analyst. Steve and I shared the same office, and we quickly became good friends. In contrast to myself, a pure fundamental analyst, Steve's approach to the markets was strictly technical. (The fundamental analyst uses economic data to forecast prices, while the technical analyst employs internal market data—such as price, volume, and sentiment—to project prices.)

Until that time, I had viewed technical analysis with great skepticism. I tended to doubt that anything as simple as chart reading could be of any value. Working closely with Steve, however, I began to notice that his market calls were often right. Eventually, I became convinced that my initial assessment of technical analysis was wrong. I realized that, at least for myself, fundamental analysis alone was insufficient for successful trading; I also needed to incorporate technical analysis for the timing of trades.

The second key element that finally put me into the winner's column was the realization that risk control was absolutely essential to successful trading. I decided that I would never again allow myself to lose everything on a single trade—no matter how convinced I was of my market view.

Ironically, the trade that I consider my turning point and one of my best trades ever was actually a loss. At the time, the Deutsche mark had carved out a lengthy trading range following an extended decline. Based on my market analysis, I believed that the Deutsche mark was forming an important price base. I went long within the consolidation, simultaneously placing a good-till-cancelled stop order just below the recent low. I reasoned that if I was right, the market should not fall to new lows. Several days later, the market started falling and I was stopped out of my position at a small loss. The great thing was that after I was stopped out, the market plummeted like a stone. In the past, this type of trade would have wiped me out; instead, I suffered only a minor loss.

Not long thereafter, I became bullish on the Japanese yen, which had formed a technically bullish consolidation, providing a meaningful close point to place a protective stop. While I normally implemented only a one-contract position, the fact that I felt reasonably able to define my risk at only 15 ticks per contract—today, I find it hard to believe that I was able to get away with that close a stop—allowed me to put on a three-contract position. The market never looked back. Although I ended up getting out of that position far too early, I held one of the contracts long enough to triple my small account size. That was the start of my success at trading. Over the next few years, the synthesis of technical and fundamental analysis combined with risk control allowed me to build my small stake into well over \$100,000.

Then the streak ended. I found myself trading more impulsively, failing to follow the rules I had learned. In retrospect, I believe I had just become too cocky. In particular, I remember a losing trade in soybeans. Instead of taking my loss when the market moved against me, I was so convinced that the decline was a reaction in a bull market that I substantially increased my position. The mistake was compounded by taking this action in front of an important government crop report. The report came out bearish, and my equity took a dramatic decline. In a matter of days, I had surrendered over one-quarter of my cumulative profits.

After cashing in my chips to buy a house and later taking a year-long sabbatical to write a book,* my savings were sufficiently depleted to defer my reentry into trading for nearly five years. When I began trading again, typical to my usual custom, I started with a small amount: \$8,000. Most of this money was lost over the course of a year. I added another \$8,000 to the account and, after some further moderate setbacks, eventually scored a few big winning trades. Within about two years, I had once again built my trading account up to over \$100,000. I subsequently stalled out, and during the past year, my account equity has fluctuated below this peak.

Although, objectively, my trading has been successful, on an emotional level, I often view it with a sense of failure. Basically, I feel that

*Jack D. Schwager, *A Complete Guide to the Futures Markets* (John Wiley & Sons, New York, NY, 1984).

given my market knowledge and experience, I should have done better. “Why,” I ask myself, “have I been able to multiply a sub-\$10,000 account more than tenfold on two occasions, yet unable to expand the equity much beyond that level, let alone by any multiples?”

A desire to find the answers was one of my motivations for writing this book. I wanted to ask those traders who had already succeeded: What are the key elements to your success? What approach do you use in the markets? What trading rules do you adhere to? What were your own early trading experiences? What advice would you give to other traders?

While, on one level, my search for answers was a personal quest to help surpass my own barriers, in a broader sense, I saw myself as Everyman, asking the questions I thought others would ask if given the opportunity.

