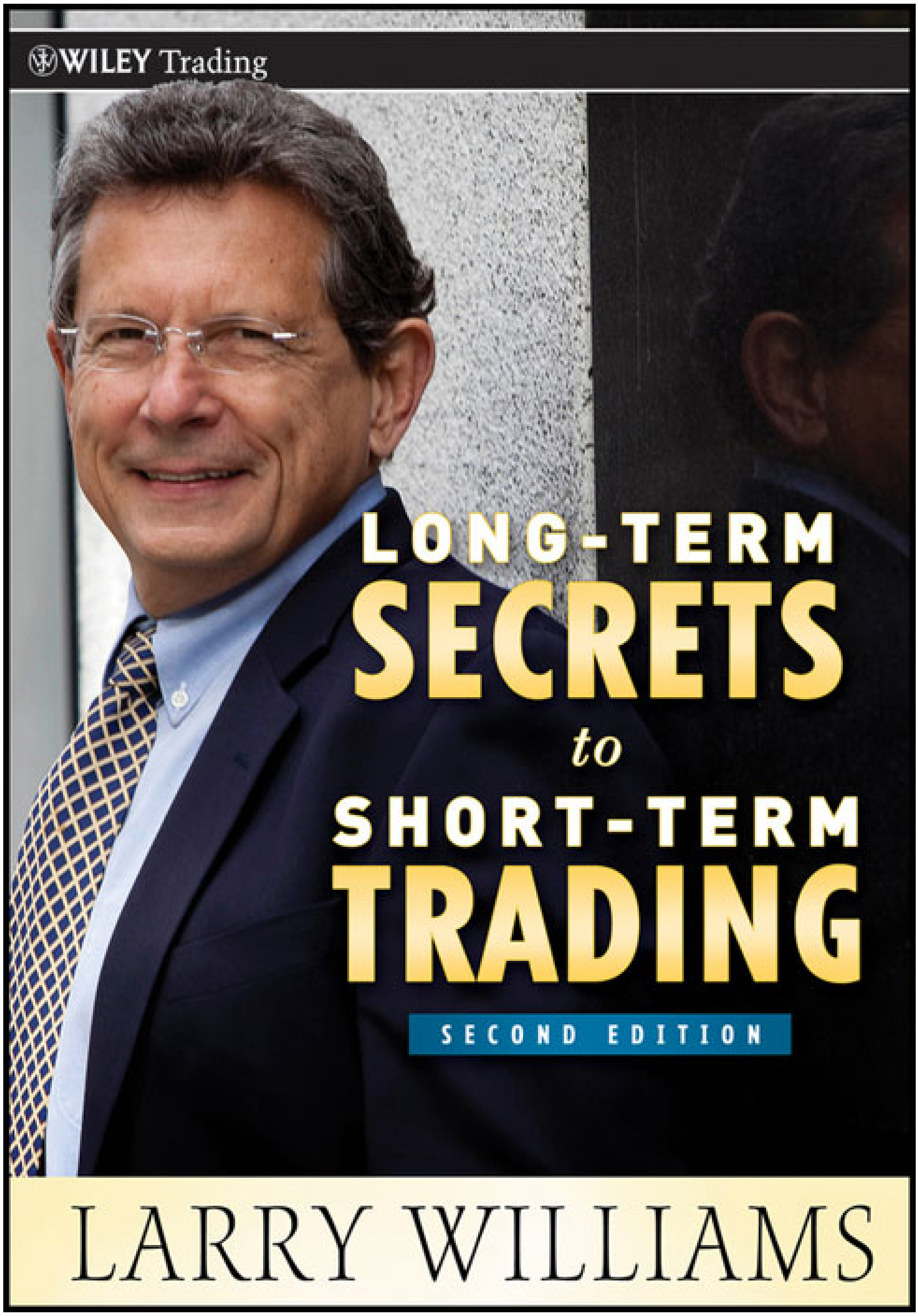
WILEY Trading

LONG-TERM SECRETS to SHORT-TERM TRADING

SECOND EDITION

LARRY WILLIAMS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Contents

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Long-Term Secrets to Short-Term Trading

Second Edition

LARRY WILLIAMS

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This book is not the product of research—it is the culmination of a career that has included a great deal of research, personal introspection, and, along the way, I hope some personal growth.

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With best wishes to all.

Larry Williams, 2011
St. Croix
US Virgin Islands

INTRODUCTION

You Are Already a Commodity Trader

In the ensuing years since the first edition of this book was published, more and more people have become stock, commodity, and Forex traders. The guy who does our yard work trades, as does my dentist and favorite chef. Why?

I suspect there is more to it than the thrill of speculation; now, more and more people want a *way out*. They don't want to be an employee, nor do they want to be a boss. They want to be independent and that seems to be possible only as a trader. It is a dream that many have followed, and which has become a surprising reality for countless traders. There is a way out ... that's what this book is really all about: showing you the tricks and techniques of my craft.

Whether you know it or not, you have been trading commodities all your life. Sure, you may have never traded a contract of Pork Bellies, but you have almost certainly traded a possession like a car, house, or antique for someone else's money or possession. If you have never done that, for sure you have traded time for money. You have traded your time as a teacher, lawyer, pipe fitter, or ditch digger for someone else's money. So, you are halfway there, you just never knew it!

When we trade our time, we are actually trading our time plus our skills. That is why a brain surgeon gets more per hour than a knee surgeon. That is also why an outstanding quarterback gets more than a tackle and surgeon combined. He has a greater career risk. It is not that one skill is inherently more valuable than the other, it is that one is more difficult to come by and carries higher risk. This characteristic generates more dollars for the person selling his or her time and skills.

There is no intrinsic value to Michael Jordan's dribbling and shooting skills, but the owner of the Chicago Bulls saw an opportunity to make a great deal of money with those seemingly valueless skills by packing stadiums and getting television revenues. Thus, something of “no value” may have great value.

At a trading seminar, I once demonstrated this point by placing a personal check in a sealed envelope and then added it to 14 similar, sealed envelopes in a clear plastic bag. The attendees each had the opportunity to reach in and draw out an envelope. The person who drew the one with the $5,000 check would be allowed to keep it.

The bag contained 14 worthless envelopes, but suddenly they had value! Although all but one were empty, there was a 1 in 15 chance of winning $5,000; thus each envelope, or opportunity to take out an envelope, was worth $333.33. Once the participants began taking envelopes out of the bag, those empty, worthless envelopes gained in value. After all, once five empty envelopes were removed, there was now a 1 in 10 chance and the value had risen to $500. When just two envelopes were left in the bag, people in the audience were willing to pay $2,500 to dip their hand in and pull out an envelope! Suddenly, what was worthless had great value!

That is your first lesson in becoming a more aggressive commodity trader. Value, like beauty, is in the mind of the beholder. As a trader, the lesson is to never second-guess what value really is: It is what the market will pay. It (the market or collective judgment of other traders) may not pay that value for long, but price is king: It is what is. I learned long ago not to argue with what is.

In 1974, I reached a value judgment that the price of Cattle would skyrocket so I began loading up, taking my first position at 43 cents a pound. I “knew the value” of Cattle; at this price, it was way under value, offering a sure trade. So, as price drifted to the 40-cent area, I bought more. After all, if 43 cents was cheap, 40 cents was even better.

At 38 cents, where price next went, I had a steal, and being no dummy, I stole some more, only to see price plummet to 35 cents, then 30 cents, and finally 28 cents—where, dear reader, I was tapped out. My resources were limited; this move cost me about $3 million, all in less than 30 days.

Two months later, the price of Cattle soared to over 60 cents a pound. But I was not there—a sure-thing trade had set me back dearly and helped contribute to rumors, afloat still today over a quarter of a century later, that I blew out trading, despite a few successes I will get to later in this book.

Reflecting on this experience over the years has enabled me to formulate two important rules. The first is that value is ephemeral: It can be anything, and anything can and will happen when trading commodities, or stocks for that matter.

The second rule, which carries greater weight, is that although market trend and direction are major concerns, knowing how to deal with your resources has the highest priority. After all, had I marshaled out my resources on the Cattle trade so I could have ridden through the bad times, I would have made a respectable killing.

You never know when the markets will do what you think they are supposed to do. Many times, like God, the market does not deny, it just delays. Serious traders weave protection against this delay into the fabric of their program. There is no greater rule to learn than that of money management. All the horror stories you have heard about commodity trading are true. Good people have been totally wiped out by doing the wrong thing. That wrong thing has never been the market, nor the fact the trader made a bad call. Indeed, every successful trader will have bad calls and losing trades. And lots of them.

The wipeouts you have heard about, every single one of them, have come from placing too large a bet on a trade or holding onto a losing position too long. The sooner you learn to master your defeats, the sooner you will be on your way to amass the wealth that is possible in this business. It is your failures, not your successes, that kill you in this business. Failures do not build character; instead they destroy your bank account.

The foundation to all your success can be found in the preceding paragraph. Psychics may or may not be able to predict the market, and value may or may not prevail. The world of speculation is about predicting the future and that is difficult at best. The fabled U.S. intelligence community, which has supposedly bankrolled and trained the brightest of the bright, was not able to predict the fall of the Berlin Wall! So how can you and I hope to do better?

Our inability to see the future is proved yearly by such august sports magazines as *Sports Illustrated.* In 1997, their oracles predicted Penn State would be the number-one football team, ranking Michigan number 18. By the end of the season, Michigan was number one and Penn State was floundering. Washington was supposed to be number three, but was beaten by lowly Washington State, a team not mentioned in any top 20 list, that went on to win the Pac 10 championship and almost upset Michigan in the Rose Bowl!

History repeats itself; Mike Tyson is living proof of that. An interesting side note here: Montana's banker of the year, a few years back, was actually embezzling bank funds. To redeem himself and pay back the thievery, he took out another $1,000,000 to bet on “Iron Mike” Tyson, who of course lost the fight against Buster Douglas. The bank buster was tapped out, discovered, and went to prison.

Who could have predicted the demise of newspapers, or Tiger Woods?

People who make their living looking into crystal balls are destined to eat a lot of broken glass.

But take heart: Although neither you nor I can divine the future, especially price action, we can learn to control our losses. That is a certainty, based on math, that will provide the building blocks for your successes. Each and every one of them.

For years, I chased the prophets of profit, those financial soothsayers who claimed that they, or their indicators, could reveal the future. Eventually, I realized that God does not want us to see the future. It is as simple as that.

If we could see “out there,” we could all be millionaires many times over. We would bet the ponies, spin the roulette wheel, and roll dice, except, of course, that no casino would back the other side of an unwinnable wager. Besides, how thoroughly boring would life become if we could know today how every day of our future would be? Who would want to live that way? Where's the joy of discovery, the magic of the unknown, the thrill of victory, the challenge of overcoming limitations?

If we could all be rich from our powers of foresight, who would work for us, grow wheat, or raise cattle? There would be no phone company, no movies, and no television, as no one would need to work. Worse yet, who would hire us?

As I have said, God in His infinite wisdom does not want us to know much about the future and, certainly, very little about the future of futures. Would-be speculators think that this is a game of knowing the future, of knowing what cannot be known. It is not. This is a game of developing strategies with winning advantages, getting the odds on your side, working those odds, and staying alert to any potential changes in the game, including new players or new ideas and concepts.

The word *speculate* comes from the Latin *specular,* meaning "to observe," as also found in the word *spectacle* (such as your eyeglasses). We are not like gamblers, who enter a game they cannot win over time. All they can do is hope that chance will run their way, not the way of the house. We speculators observe how things should happen in the future, but because we know there are no guarantees, we protect our positions with appropriate techniques to preserve capital, so that we can win at our game.

The art of speculation requires one part observation tossed together with one rather large dose of preservation.

MY MOST IMPORTANT MARKET BELIEF

Based on my research and experience, I have developed a powerful and profitable belief system:

> *I believe the current trade I am in will be a loser ... a big loser at that.*

This continues to be my most important market mantra. Winners we can handle, it's the losses that kill you.

This may sound pretty negative to all you positive thinkers, but positive thinking can give way to thinking you will win—a surefire formula for buying and selling too many contracts and holding on too long. After all, if you are positive things will work out, you are certain to hold for a bounce or turn that never comes.

I look at it this way: If you get all pumped up over positive beliefs about your market success, your conviction will lead you to mismanage losing trades. That is why belief systems are so important to a trader. If your belief system tells you that your current trade will be a winner—and it isn't—the need to confirm that belief in your mind will literally force you to let losses run, to stay with losers, which is something that no successful trader ever does. An outrageously positive belief that the next trade or two will turn your account around or make a small fortune for you is most dangerous.

Now let's look at my belief that the current trade I am in will be a loser, that I have no pact with God for success on this trade. Indeed, I genuinely believe the market is not precisely perfect. Keep in mind that the data for this belief overwhelmingly supports it: 75 percent of mutual fund managers do not outperform the Dow, 80 percent of short-term traders lose their risk capital. On a personal note, many of my own trades do not make money, and I can positively guarantee that many of yours will not succeed.

No major loss I have ever had, and I have had more than my fair share of them, has been the market's “fault.” “They” were never out to get me. I got myself by believing my current trade would be a winner, which led me to neglect to follow the rules of the game.

I agree with those who say you are only as powerful as your belief system because that belief will give you the power of taking an action with more certainty and less hesitation. We act out what we believe: Those mental beliefs are the scriptwriters for our play of life.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will protect yourself with stops. You will control disasters, taking the first lifeboat possible instead of going down with a sinking ship.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will not load up on a trade, banking on it to bail out all your problems. A tiny loss can wipe you out when you have taken a very large position or number of shares or contracts.

Positive beliefs about future results cause us to take on undue risk. Doing that in a game where the odds are unfavorable to begin with is a sure invitation to disaster.

THE BEGINNING OF MY CAREER AS A SPECULATOR

I ride rodeo because I'm too lazy to work and too honest to steal.

—Freckles Brown, world champion bull rider

My career as a speculator began in the seventh grade when a kid named Paul Highland showed me how much money could be made flipping coins, matching quarters, or odd-man-out for the shiny silver dollars we lugged around in our Levi's. Growing up in Billings, Montana, was an excellent precursor to speculation. Flipping quarters was my start; sure I lost some, but if there was anything I understood, other than my art classes and playing football, it was that there was plenty of really easy money to be made gambling for quarters and dollars.

It may well be that everything I needed to know about speculation I learned in junior high school. It took a while, but I finally figured out that Paul and Virgil Marcum were taking my money by teaming up. One would control his coin so a head came up, the other a tails so I could not win. Later they split the proceeds, and I had my first lesson on market manipulation.

I did not call the police or any authorities. I handled it in my own way, and to this day distrust the bureaucrats that are supposed to right such wrongs. They don't … at least not in time to help you or me.

Jack McAferty was the toughest kid in Billings. Fact is, he was the toughest kid in the entire state of Montana and that's saying a lot, considering the number of cowboys, roughnecks, and miners we had in the Treasure State. When a big guy hits you on the arm it hurts. When Jack, who was not a big guy, socked you on the arm, your bone ached. He had unbelievable power, which served him well in every single fight I ever saw him in. No one came close. Fighting became his way of life, but Jack was killed by an L.A. policeman, supposedly on a freeway chase. The truth, however, is that Jack, a real ladies' man, had been dating the cop's wife.

Most of the guys who were coin-matching speculators would not play with Jack. Usually he would pay off and give you his quarter, but if he decided not to, what was your choice? Threaten him and get the living crap beat out of you? Ah, another lesson in speculation: Choose your partners and business associates carefully.

Years later, we took a $5,000 account to over $40,000 by trading a Cattle system that Richard Ulmer developed. This happened at a brokerage firm owned by George Lane, a guy who claims he is the originator of the widely followed Stochastics Index. Well, George did not invent Stochastic, and I did not get my $40,000 from the brokerage. The regulators closed old George up, and just before they did the funds were drained from my account!

Another thing I learned from Jack was that strong people do not respect weak ones. I had put up with enough of Jack's reneging on our coin flips so that when he decided not to pay up and kept his quarter, I blasted him in the stomach as hard as I could. Astonished, he glared at me, asking, “Why the hell did you do that? You know I'm going to clean your clock now.”

All I could say was, “Well, go ahead and do it, I'm just tired of you not playing by the rules. I know you're going to break every bone in my body and you'll get a lot of pleasure out of that, but it won't compare to how I feel knowing I stood up to you.”

Jack shot back, “I like that, I respect you,” handed me the quarter I had just won, and walked away. We became pretty good friends after that, but we never matched coins again.

Everyone in Montana works hard. Certainly, my dad worked as hard as anyone, putting in over 40 hours a week, then more hours on weekends at Doc Zinc's stinky sulfur refinery. And as if that weren't enough, he would stay up late at night reading books, taking courses on electronics so he would be more valuable to Conoco, his career employer. The gambit of hard work and loyalty paid off—he got promoted.

One of the advantages of having a father working at the refinery was that his kids could get summer jobs there if they were in college. I did that, too, and it re-inforced my strong desire to not do what these guys did: work. They worked long hours, ever-changing shift work. One week, you went to work at 3:30 PM, the next week at 11:30 PM, and the following week you might pull the 3:30 shift or start at 7:30 AM There was neither rhyme nor reason to the schedules that I could see. All I saw was the unending hours of voluntary servitude in a hot, stench-filled, noisy refinery, a place where nothing made sense to me.

There must be a million valves in an oil refinery and I am certain they all turn on and off the same way. My problem was I could never figure out which way was the right way. That was frustrating, not only because it showed my ineptitude, but also because it also reflected on my father, who had all this mechanical stuff down pat. There really was nothing mechanical he could not fix. If I were to have open-heart surgery, I would trust him more than a doctor.

Dad knew how to build things (our house, delicate cabinetry for Mom) and knew how to fix things—in part, I am sure, because we did not have money to pay to get things fixed. Poor people develop more skills than rich people.

My ineptness also held me up to ridicule when people compared me with my older brother, who just naturally knew what to do at the refinery, and seemingly got along well with the older men. My general laziness coupled with a desire to be alone and a total inability to do anything well, but draw, caused me to feel inadequate. My initial response to find self-esteem came from sports. But that sense of approval only lasts through the game. I would lay awake in bed dreaming, scheming about a way to have a better life, wondering how the few people with really big houses achieved success. I was not content; what I wanted was a way out.

Flipping coins seemed reasonable; making fake driver's licenses (for $5 each, and fake birth certificates for $20) paid a lot better. My limited artistic talents made more money and let me work by myself. It also included a healthy dose of risk. I liked knowing that I was doing something the average person couldn't or wouldn't; and I certainly was not going to find that kind of satisfaction in what I saw at the time as my father's humdrum existence. My dad did everything by the book and followed all the rules—with one exception.

When deer season came, the rulebook went out the window. We killed enough deer, antelope, and elk to feed our family for the year. We used the same deer tag or license three or four times. When it comes to survival, I learned there are no rules: People must take risks, even my Pops. What did I like most about those hunting trips: bagging my deer or taking the chance of getting caught with too many deer, fish, or other game? I have often thought about that. In their own way, they are both thrilling—my speculative career began on a roll.

Really good speculators like thrill, indeed they seek it out, as some sort of intellectual rush.

Maybe that is why I liked selling newspapers on the street corners after school, or selling Christmas cards and garden seeds door-to-door to pick up spending money. I was at risk, never knowing if I would make a sale, but I also might make some decent money for just being there, talking, and showing some stuff.

I had seen enough hard work to know I did not covet it. Like rodeo riders, I was "too lazy to work" and had been raised to be "too honest to steal." Hence going to college or joining the Navy after high school seemed to be the right direction, and it was one that my mom and dad encouraged. They always told us to do better, that there was an easier life, and that college was the door to that life.

In 1962, I asked someone what the "most active" list of stocks in the newspaper meant. I was hooked when he replied, "Well, see that the stock for General Motors was up 1.5 for the day? Had you bought it yesterday, you would have made $150 today."

$150 in one day!

Wow, this sure beat flipping quarters! Back then, $150 was more than guys at the refinery made in a week. This looked easy, and the winnings were staggering. My only two questions were, how did one get started and where had I been all my life? There was an instant affinity between me and what looked like easy money!

That affinity led to the greatest challenge of my life, something I have worked hard at just about every day since 1962. Really, my only time off from the markets occurred when I ran for the U.S. Senate in 1978 and 1982. Other than those two interruptions, I have spent every day of my life "working," much to my father's pleasure, I am certain, but it has never resembled work at the refinery or the jobs I held during and after college.

From this experience, I believe three motivators are found in the heart of a successful speculator: an intense desire to make a lot of money, a longing or yearning to show somebody else up, and an internal discontent with how things are. Great big chunks of unrest seem to be an important asset for a speculator. Although most people seek balance in their life, I have never found that very healthy; no great achievements were ever made by perfectly normal people. Sometimes I think about living a more balanced life. That thought usually lasts a couple of seconds. I guess my unrest will never go away, but if my lifestyle suggests anything, it is that unrest fans the flames of a speculator's internal fires.

THE RIDE OF A LIFETIME

I would probably trade the markets without wanting profits if it proved my worth to the world, to an old girlfriend, to my parents, my brother, or even to someone I cannot identify or dredge from the recesses of my mind. Saying I am ego-driven may be correct, but it is not about bragging, it is about showing them that I can overcome adversity.

It is about letting the world know that I found a way out. This book is about showing you that same door; it is about showing you what I learned over the past few years, how the markets have changed, and what we can do to continue as successful traders.

There is so much more I have learned in the past few years; above all, I have learned to adapt to market changes, so you will be learning more than a few more *Long-Term Secrets to Short-Term Trading* … you will also learn the art of adaptation.

If these words have resonance for you, cinch up your seat belt, you are going on the ride of your life.

The ride has continued for me, while most who are my age, the cusp of 70 years now, are retired and content to surf the Internet and doze away while watching *American*