Jack Schwager: Market insider

by Mark Etzkorn

Article Contributed by Active Trader Magazine

Author, analyst and trader Jack Schwager discusses what separates great traders from merely profitable ones, and what happens when people think “things are different this time” in the stock market.

Every aspiring trader wants to know the secrets of various “Super Traders,” hoping to mimic their success by acquiring those bits of secret knowledge or mysterious insights such market masters surely must possess. From Jesse Livermore to George Soros, top traders have always captured the public’s imagination but have often, by their own choice, remained mysteries — which only adds to their allure.

Few people have had a better opportunity to pick the brains of high-level traders than Jack Schwager. His latest book, Stock Market Wizards (Harper Business, 2001), profiles 15 exceptional stock market players (actually, 14 traders and one trading coach/psychiatrist) and is the latest installment in a series of books that have become required reading for serious traders and investors (see “The paper trader,” Active Trader, May 2000, p. 30, and the book review accompanying this interview).

What Schwager seems to have found over the years is that, while there might be an element of native talent involved, there really aren’t any secrets when it comes to trading. Top traders — from a personality perspective, at least — share many of the same characteristics and habits, regardless of what kind of trading approach they use. However, that still doesn’t mean excellence in the markets comes easy, something the author knows from personal experience.

Schwager, who earned a master’s in economics from Brown University, started his career as a commodity analyst in the early 1970s and spent more than 22 years as the director of futures research at several Wall Street firms, including Prudential Securities. He branched into money management as a commodity trading advisor (CTA) in the 1990s, all the while penning several highly regarded analysis and trading books, including A Complete Guide to the Futures Markets (John Wiley & Sons, 1984), Schwager on Futures: Fundamental Analysis (John Wiley & Sons, 1995), Schwager on Futures: Technical Analysis (John Wiley & Sons, 1995), Schwager on Futures: Managed Trading (John Wiley & Sons, 1996) and Getting Started in Technical Analysis (John Wiley & Sons, 1999).

But he is probably best known for the Wizards books, the first of which grew from his desire to improve his own trading performance. Although profitable, he felt he had hit a brick wall in his personal account, and so got the idea to talk to top traders about what they do and how they do it. Market Wizards (New York Institute of Finance, 1989) was the result of those conversations. He followed up with The New Market Wizards (Harper Business) in 1992. The traders he talked to in these books included Richard Dennis, William O’Neil, Jim Rogers, Marty Schwartz, Paul Tudor Jones and Monroe Trout.

Although he has spent a great deal of his career on the futures side of the business, Schwager found himself moving solidly toward stock traders when he first started doing research for the new book.

“It had been around eight years since I’d done the last Wizards book, and I really began by thinking, ‘What am I going to call this thing? I can’t call it New New Market Wizards,’” he says. “At the same time, most of the names I was coming up with in my search for new traders were stock or stock derivative traders. And, of course, there was a lot of public interest in the stock market. So it seemed like a natural thing to focus just on stock traders.”

Schwager, 52, has entered another phase of his career, in part inspired by the work he did for his latest book. He’s the managing member of Market Wizards Funds L.L.C., a fund of funds he started based on the assumption that “an investment that makes sense for me will make sense for other people,” he says. “It was an outgrowth of the book, actually. In the process of doing it, I was investing with some of the people I was interviewing. I didn’t have
remotely enough money to diversify among all the managers I wanted to invest with, so I thought the only way to do it would be to have a fund that invested in many of the people I was finding. My own investing was the initial catalyst.”

In early February, we talked to him about his new book, what makes top traders tick and his take on the current market.

AT: Do the traders in Stock Market Wizards share many of the same characteristics as the traders you interviewed in your other books?

JS: Some of the themes are consistent, especially in terms of personal characteristics or traits, such as being really driven — almost to an obsessive degree — being very disciplined, and the ability to be patient and wait for trades to come through.

But then there are things that are particular to the stock market that wouldn’t have come up in the previous books. Here’s one example: It’s striking how important the idea of a catalyst (a specific market event, such as a news item, that launches a move in a stock) was to trading stocks, particularly on the short side. Many of the traders said catalysts were integral to their approaches, in different ways. You wouldn’t necessarily find that among traders in general. Also, insider trading (tracking what company insiders are doing with their shares), which simply doesn’t exist in futures or currency markets, was very important to a number of traders.

Another important difference between futures or currency traders and equity traders is their respective motivations for liquidating positions. Futures and currency traders will hold a position as long as they think it will go their way. For these traders in leveraged instruments, the availability of funds is not usually an important consideration.

By contrast, a number of the stock traders I interviewed in the current book stressed that they will often get out of a stock if the money can be better applied to another stock they believe will go up even more. One trader used a pigs-at-a-trough analogy: If a pig on the outside wants to eat, he has to push aside another pig to make room. So the question they ask themselves is not, “Will this stock go higher?” but rather “Will this stock go higher than any other stock I can own?”

AT: Have you found that stock traders are less systematic than futures traders?

JS: Generally that’s true. There are very few systematic stock traders — at least, not systematic in the way many futures traders think of trading systems, in terms of buy and sell signals. Only one trader I interviewed was purely systematic in that regard — Steve Lescarbeau, who is a fund timer.

However, there was also David Shaw (founder of D.E. Shaw) who uses a totally computerized approach — market neutral arbitrage involving thousands of stocks across worldwide equity markets — employing scores of complex mathematical models. Now, in one sense that is certainly a systematic approach, but it has nothing to do with the conventional concept of trading systems.

AT: In his interview, Mark Cook said he’ll risk two points to make one point. Were there any surprises for you in talking to these traders — things that flew in the face of what you considered to be sound trading principles or techniques?

JS: In the case of Mark Cook, he has a number of set trades. In one of them he’ll risk six (S&P) points to make three, but his probability of success is above 80 percent.

I was certainly amazed at some of the results — the return-to-risk performance — of some of the traders. There were a number of traders with near triple-digit returns and single-digit worst drawdowns. Take Lescarbeau, who made 70 percent compounded with a worst drawdown of less than four percent. Some of the great futures or currency traders I’ve talked to have terrific gains, but they weren’t able to do it while keeping single-digit drawdowns.
It’s also interesting how different the approaches of successful traders can be. The dichotomy of fundamental vs. technical trading has come up in every book, but here you have several people who are purely fundamental, but are still trading in completely different ways. Take Ahmet Okumus, who is very value-oriented — always looking for extreme bargain stocks — and compare him with someone like Stuart Walton.

AT: So, in the abstract, what would you look for in a trader whom you would want to trade your money?

JS: What I’m looking for is someone with exceptional performance from a return-to-risk standpoint. It’s not just enough for someone to make 80 percent a year; if they also regularly have 40 percent drawdowns, they’re not going to fit the bill. Someone making 80 percent per year with a 10 percent drawdown — now that’s impressive. Or someone who consistently makes 20 to 40 percent with drawdowns measured in a couple of percent would also work. Basically, I’d want the return-to-risk balance to be exceptional.

Another interesting point is that when you put together a book, you don’t have to worry whether people are correlated. When you’re putting together a fund of funds, you really want to make sure the people have relatively low correlation because that gives you much more risk control.JS: It’s much more difficult. If you look at the universe of futures traders who are performing best, you’ll find a high level of correlation, much higher than in equities. The range of successful methodologies in equities is much wider than in futures, where so many of the successful approaches have trend following as a key element — sometimes as a total element.

AT: Is it more difficult for futures fund managers to be uncorrelated?

JS: It’s much more difficult. If you look at the universe of futures traders who are performing best, you’ll find a high level of correlation, much higher than in equities. The range of successful methodologies in equities is much wider than in futures, where so many of the successful approaches have trend following as a key element — sometimes as a total element.

AT: Is trading — as an intellectual subject, as well as a practice — simpler to you now than when you started?

JS: Well, at the moment, I’m not actually trading. If I were to decide I wanted to trade again, it would be easier just from the sense that I would know what’s right and what’s not right, in terms of the broader themes: have a specific methodology, know what your edge is and so on. But as I said, at this point I’d rather devote my energies to writing books and finding people who can do this better than I can. I’ve realized, “Hey, I’m not going to be an exceptional trader, so I may as well do things that I’m better at.”

AT: So do you think there’s ultimately some innate skill in successful trading, or do you think the skill can be acquired?

JS: On some level there’s an innate skill. In talking to many of these traders and sometimes watching them enter trades, I have often come away with the feeling that they have an instinctive talent. Exceptional traders can look at so many factors, and yet still isolate which ones are most important at a given moment in time. Part of that is certainly a natural talent. Can it be learned? To some extent. At the end of the book I list 65 rules and concepts derived from the interviews. Anyone who follows a certain set of rules or principles like these could be a net profitable trader. But being net profitable and being a Market Wizard are two different things. To be the latter, you need that extra talent. You can read all the books you want, and you’re not going to be Steve Cohen (one of the traders interviewed in the book).

AT: What’s your impression of everything that’s happened in the stock market in recent years, and the perhaps unprecedented popularity in stock trading?

JS: It wasn’t, I think, a healthy situation. One of the themes in many of the interviews was recognition of the irrationality of what was going on at the time the interviews were taking place, in 1999 and early 2000 — the “This-
time-it’s-different” mentality. In fact, a key lesson that has come up in each of my books revolves around this concept.

In this particular case, the “This-time-it’s-different” story was, “Well, yes, the stock may be trading at tremendous multiples or at a huge capitalization without even the hint of any profits on the horizon, but companies no longer need profits to go up. It’s good enough if they have a good long-term story and the prospect of big growth sometime out in the future.” The bullish proponents in a mania always seem to find an exception that rationalizes the situation.

But of course, these exceptions didn’t hold — they never do. That’s the trap that appears repeatedly in different markets — in the Japanese stock market in the mid- to late ‘80s, or in the inflationary boom in the late ‘70s and the beginning of 1980, highlighted by a market like gold. You always have markets that reach totally irrational levels and people say, “It’s trading way beyond anything historically justified, but there’s a reason.” But the reason never holds up.

I remember watching news programs in which they’d interview ordinary people about the market, and the subjects would say they were looking to make 20 to 30 percent a year. People were becoming complacent about making that much, as if that were the norm. That’s a very dangerous way to think.

See also: Stock Market Wizards Review, Jack Schwager