

The "Not So Simple" Rules of Trading

by [John Mauldin](#)

The rules that should be 'Utterley Simple Rules of Trading' but which we all seems to find 'Utterley Difficult!'

The world of investing/trading, even at the very highest levels, where we are supposed to believe that wisdom prevails and profits abound, is littered with the wreckage of wealth that has hit the various myriad rocks that exist just beneath the tranquil surface of the global economy. It matters not what level of supposed wisdom, or education, that the money managers or individuals in question have. We can make a list of wondrously large financial failures that have come to flounder upon these rocks for the very same reasons. Let us, for a bit, have a moment of collective silence for Long Term Capital Management; for Baring's Brothers; for Sumitomo Copper... and for the tens of thousands of individuals each year who follow their lead into financial oblivion.

I've been in the business of trading since the early 1970s as a bank trader, as a member of the Chicago Board of Trade, as a private investor, and as the writer of The Gartman Letter, a daily newsletter I've been producing for primarily institutional clientele since the middle 1980s. I've survived, but often just barely. I've made preposterous errors of judgment. I've made wondrously insightful "plays." I've understood, from time to time, basis economic fundamentals that should drive prices--and then don't. I've misunderstood other economic fundamentals that, in retrospect, were 180 degrees out of logic and yet prevailed profitably. I've prospered; I've almost failed utterly. I've won, I've lost, and I've broken even.

As I get older, and in my mid-50s, having seen so much of the game--for a game it is, with bad players who get lucky; great players who get unlucky; mediocre players who find their slot in the lineup and produce nice, steady results over long periods of time; "streak-y" players who score big for a while and lose big at other times--I have distilled what it is that we do to survive into a series of "Not-So-Simple" Rules of Trading that I try my best to live by every day ... every week ... every month. When I do stand by my rules, I prosper; when I don't, I don't. I am convinced that had Long Term Capital Management not listened to its myriad Nobel Laureates in Economics and had instead followed these rules, it would not only still be extant, it would be enormously larger, preposterously profitable and an example to everyone. I am convinced that had Nick Leeson and Barings Brothers adhered to these rules, Barings too would be alive and functioning. Perhaps the same might even be said for Mr. Hamanaka and Sumitomo Copper.

Now, onto the Rules:

NEVER ADD TO A LOSING POSITION RULE 1

Never, ever, under any circumstance, should one add to a losing position ... not EVER!

Averaging down into a losing trade is the only thing that will assuredly take you out of the investment business. This is what took LTCM out. This is what took Barings Brothers out; this is what took Sumitomo Copper out, and this is what takes most losing investors out. The

only thing that can happen to you when you average down into a long position (or up into a short position) is that your net worth must decline. Oh, it may turn around eventually and your decision to average down may be proven fortuitous, but for every example of fortune shining we can give an example of fortune turning bleak and deadly.

By contrast, if you buy a stock or a commodity or a currency at progressively higher prices, the only thing that can happen to your net worth is that it shall rise. Eventually, all prices tumble. Eventually, the last position you buy, at progressively higher prices, shall prove to be a loser, and it is at that point that you will have to exit your position. However, as long as you buy at higher prices, the market is telling you that you are correct in your analysis and you should continue to trade accordingly.

R U L E 2

Never, ever, under any circumstance, should one add to a losing position ... not EVER!

We trust our point is made. If "location, location, location" are the first three rules of investing in real estate, then the first two rules of trading equities, debt, commodities, currencies, and so on are these: never add to a losing position.

INVEST ON THE SIDE THAT IS WINNING R U L E 3

Learn to trade like a mercenary guerrilla.

The great Jesse Livermore once said that it is not our duty to trade upon the bullish side, nor the bearish side, but upon the winning side. This is brilliance of the first order. We must indeed learn to fight/invest on the winning side, and we must be willing to change sides immediately when one side has gained the upper hand.

Once, when Lord Keynes was appearing at a conference he had spoken to the year previous, at which he had suggested an investment in a particular stock that he was now suggesting should be shorted, a gentleman in the audience took him to task for having changed his view. This gentleman wondered how it was possible that Lord Keynes could shift in this manner and thought that Keynes was a charlatan for having changed his opinion. Lord Keynes responded in a wonderfully prescient manner when he said, "Sir, the facts have changed regarding this company, and when the facts change, I change. What do you do, Sir?" Lord Keynes understood the rationality of trading as a mercenary guerrilla, choosing to invest/fight upon the winning side. When the facts change, we must change. It is illogical to do otherwise.

DON'T HOLD ON TO LOSING POSITIONS R U L E 4

Capital is in two varieties: Mental and Real, and, of the two, the mental capital is the most important.

Holding on to losing positions costs real capital as one's account balance is depleted, but it can exhaust one's mental capital even more seriously as one holds to the losing trade, becoming more and more fearful with each passing minute, day and week, avoiding potentially profitable trades while one nurtures the losing position.

GO WHERE THE STRENGTH IS RULE 5

The objective of what we are after is not to buy low and to sell high, but to buy high and to sell higher, or to sell short low and to buy lower.

We can never know what price is really "low," nor what price is really "high." We can, however, have a modest chance at knowing what the trend is and acting on that trend. We can buy higher and we can sell higher still if the trend is up. Conversely, we can sell short at low prices and we can cover at lower prices if the trend is still down. However, we've no idea how high high is, nor how low low is.

Nortel went from approximately the split-adjusted price of \$1 share back in the early 1980s, to just under \$90/share in early 2000 and back to near \$1 share by 2002 (where it has hovered ever since). On the way up, it looked expensive at \$20, at \$30, at \$70, and at \$85, and on the way down it may have looked inexpensive at \$70, and \$30, and \$20--and even at \$10 and \$5. The lesson here is that we really cannot tell what is high and/or what is low, but when the trend becomes established, it can run far farther than the most optimistic or most pessimistic among us can foresee.

RULE 6

Sell markets that show the greatest weakness; buy markets that show the greatest strength.

Metaphorically, when bearish we need to throw our rocks into the wettest paper sack for it will break the most readily, while in bull markets we need to ride the strongest wind for it shall carry us farther than others.

Those in the women's apparel business understand this rule better than others, for when they carry an inventory of various dresses and designers they watch which designer's work moves off the shelf most readily and which do not. They instinctively mark down the work of those designers who sell poorly, recovering what capital then can as swiftly as they can, and use that capital to buy more works by the successful designer. To do otherwise is counterintuitive. They instinctively buy the "strongest" designers and sell the "weakest." Investors in stocks all too often and by contrast, watch their portfolio shift over time and sell out the best stocks, often deploying this capital into the shares that have lagged. They are, in essence, selling the best designers while buying more of the worst. A clothing shop owner would never do this; stock investors do it all the time and think they are wise for doing so!

MAKING "LOGICAL" PLAYS IS COSTLY RULE 7

In a Bull Market we can only be long or neutral; in a bear market we can only be bearish or neutral.

Rule 6 addresses what might seem like a logical play: selling out of a long position after a sharp rush higher or covering a short position after a sharp break lower--and then trying to play the market from the other direction, hoping to profit from the supposedly inevitable correction, only to see the market continue on in the original direction that we had gotten ourselves exposed to. At this point, we are not only losing real capital, we are losing mental

capital at an explosive rate, and we are bound to make more and more errors of judgment along the way.

Actually, in a bull market we can be neutral, modestly long, or aggressively long--getting into the last position after a protracted bull run into which we've added to our winning position all along the way. Conversely, in a bear market we can be neutral, modestly short, or aggressively short, but never, ever can we--or should we--be the opposite way even so slightly.

Many years ago I was standing on the top step of the CBOT bond-trading pit with an old friend Bradley Rotter, looking down into the tumult below in awe. When asked what he thought, Brad replied, "I'm flat ... and I'm nervous." That, we think, says it all...that the markets are often so terrifying that no position is a position of consequence.

R U L E 8

"Markets can remain illogical far longer than you or I can remain solvent."

I understand that it was Lord Keynes who said this first, but the first time I heard it was one morning many years ago when talking with a very good friend, and mentor, Dr. A. Gary Shilling, as he worried over a position in U.S. debt that was going against him and seemed to go against the most obvious economic fundamentals at the time. Worried about his losing position and obviously dismayed by it, Gary said over the phone, "Dennis, the markets are illogical at times, and they can remain illogical far longer than you or I can remain solvent." The University of Chicago "boys" have argued for decades that the markets are rational, but we in the markets every day know otherwise. We must learn to accept that irrationality, deal with it, and move on. There is not much else one can say. (Dr. Shilling's position shortly thereafter proved to have been wise and profitable, but not before further "mental" capital was expended.)

R U L E 9

Trading runs in cycles; some are good, some are bad, and there is nothing we can do about that other than accept it and act accordingly.

The academics will never understand this, but those of us who trade for a living know that there are times when every trade we make (even the errors) is profitable and there is nothing we can do to change that. Conversely, there are times that no matter what we do--no matter how wise and considered are our insights; no matter how sophisticated our analysis--our trades will surrender nothing other than losses. Thus, when things are going well, trade often, trade large, and try to maximize the good fortune that is being bestowed upon you. However, when trading poorly, trade infrequently, trade very small, and continue to get steadily smaller until the winds have changed and the trading "gods" have chosen to smile upon you once again. The latter usually happens when we begin following the rules of trading again. Funny how that happens!

**THINK LIKE A FUNDAMENTALIST;
TRADE LIKE A TECHNICIAN
R U L E 10**

To trade/invest successfully, think like a fundamentalist; trade like a technician.

It is obviously imperative that we understand the economic fundamentals that will drive a market higher or lower, but we must understand the technicals as well. When we do, then and only then can we, or should we, trade. If the market fundamentals as we understand them are bullish and the trend is down, it is illogical to buy; conversely, if the fundamentals as we understand them are bearish but the market's trend is up, it is illogical to sell that market short. Ah, but if we understand the market's fundamentals to be bullish and if the trend is up, it is even more illogical not to trade bullishly.

R U L E 11

Keep your technical systems simple.

Over the years we have listened to inordinately bright young men and women explain the most complicated and clearly sophisticated trading systems. These are systems that they have labored over; nurtured; expended huge sums of money and time upon, but our history has shown that they rarely make money for those employing them. Complexity breeds confusion; simplicity breeds an ability to make decisions swiftly, and to admit error when wrong. Simplicity breeds elegance.

The greatest traders/investors we've had the honor to know over the years continue to employ the simplest trading schemes. They draw simple trend lines, they see and act on simple technical signals, they react swiftly, and they attribute it to their knowledge gained over the years that complexity is the home of the young and untested.

UNDERSTAND THE ENVIRONMENT

R U L E 12

In trading/investing, an understanding of mass psychology is often more important than an understanding of economics.

Markets are, as we like to say, the sum total of the wisdom and stupidity of all who trade in them, and they are collectively given over to the most basic components of the collective psychology. The dot-com bubble was indeed a bubble, but it grew from a small group to a larger group to the largest group, collectively fed by mass mania, until it ended. The economists among us missed the bull-run entirely, but that proves only that markets can indeed remain irrational, and that economic fundamentals may eventually hold the day but in the interim, psychology holds the moment.

And finally the most important rule of all:

THE RULE THAT SUMS UP THE REST

R U L E 13

Do more of that which is working and do less of that which is not.

This is a simple rule in writing; this is a difficult rule to act upon. However, it synthesizes all the modest wisdom we've accumulated over thirty years of watching and trading in markets.

Adding to a winning trade while cutting back on losing trades is the one true rule that holds--and it holds in life as well as in trading/investing.

If you would go to the golf course to play a tournament and find at the practice tee that you are hitting the ball with a slight "left-to-right" tendency that day, it would be best to take that notion out to the course rather than attempt to re-work your swing. Doing more of what is working works on the golf course, and it works in investing.

If you find that writing thank you notes, following the niceties of life that are extended to you, gets you more niceties in the future, you should write more thank you notes. If you find that being pleasant to those around you elicits more pleasantness, then be more pleasant.

And if you find that cutting losses while letting profits run--or even more directly, that cutting losses and adding to winning trades works best of all--then that is the course of action you must take when trading/investing. Here in our offices, as we trade for our own account, we constantly ask each other, "What's working today, and what's not?" Then we try to the very best of our ability "to do more of that which is working and less of that which is not." We've no set rule on how much more or how much less we are to do, we know only that we are to do "some" more of the former and "some" less of the latter. If our long positions are up, we look at which of those long positions is doing us the most good and we do more of that. If short positions are also up, we cut back on that which is doing us the most ill. Our process is simple.

We are certain that great--even vast--holes can and will be proven in our rules by doctoral candidates in business and economics, but we care not a whit, for they work. They've proven so through time and under pressure. We try our best to adhere to them. This is what I have learned about the world of investing over three decades. I try each day to stand by my rules. I fail miserably at times, for I break them often, and when I do I lose money and mental capital, until such time as I return to my rules and try my very best to hold strongly to them. The losses incurred are the inevitable tithe I must make to the markets to atone for my trading sins. I accept them, and I move on, but only after vowing that "I'll never do that again."