

AN EXECUTIVE SUMMARY OF

HEDGE FUND MARKET WIZARDS

HOW WINNING TRADERS WIN by Jack Schwager

Who is Jack Schwager

Jack Schwager is a renowned industry expert in investing, hedge funds, and futures. Best known for his Market Wizards book series, he has written extensively about hedge funds. With a BA in Economics from the Brooklyn College and also an MA in Economics from Brown University, Schwager is currently serving as a co-portfolio manager for the very prestigious ADM Investor Services Diversified Strategies Fund. His newest book is: **Hedge Fund Market Wizards: How Winning Traders Win.**

Preston and Stig's General Thoughts on the Book

We often say that people learn best by broadening their exposure to other ideas and strategies. That surely happened here as the 15 different investors interviewed in this book used very different strategies? Our main take away was that you should find the style that fits your personality best. The majority of this book was filled with strategies that we have no clue how to implement, nor do we intend to implement in the foreseeable future. They were not all bad strategies; just a lot of them weren't compatible with our personality.

Instead I would say that it's an important book to read for any investors that aspires to manage money professionally. No matter which type of investor you are, you will surely get lots of new ideas. This book will give you feedback on your current strategy, and why the rules of investing might be changing for your current strategy.

Preface

Hedge Fund Market Wizards provides a microscopic view of the world of hedge funds. Through a set of interviews conducted with the help of some of the best traders in the world, Jack Schwager determines the reason for their repeated success. With rare insights from Colm O'Shea, Michael Platt, Ray Dalio and many other highly recognized traders, this book reveals successful methods and techniques employed by those brilliant minds.

Chapter 1: Colm O'Shea

It is often believed that a trader with an ability to predict major fluctuations in world markets is successful, and Colm O'Shea represents the few that have been able to do that successfully. He's a global macro trader that asserts his intuitive capability to recognize changes rather than speculating and forecasting. For instance, O'Shea recognized that the market conditions from 2005 to 2007 exceeded high risks and instead of forecasting what could happen, he remained with bullish positions at that particular time. He says that rather than forecasting he looks back and tries to

understand what happened and react on that. When the Libor rate spiked in August 2007, confirming that the markets were going to roll over due to liquidity drying up, he switched to bearish positions because he acknowledged the significance of that event. He says that fundamentals are not important before people starts to care.

O'Shea asserts that the way a trade is implemented is much more imperative than the trade itself. His methods are to implement trades that offer the best return to risk while limiting losses if the trade goes awry. He also warns traders to first recognize where they are wrong and then set stops. He further states that although money management discipline can prevent a loss, it can fail in preventing other major losses if the stop point is not consistent with the trade analysis.

Chapter 2: Ray Dalio

Ray Dalio, the CIO, former CEO, founder and mentor of Bridgewater Associates (over \$120 billion in assets) stresses the importance of diversification. According to him, the return/risk factor when coupled with uncorrelated assets can be improved significantly. He also warns people who focus on correlation that it's a dangerous tactic because it can be grossly misleading to construct diversified portfolios. To ensure that you have a diversified portfolio, it is imperative to pick assets with different drivers. Dalio calls diversification "The holy grail of investing".

Markets act differently in different situations. Fundamental models with static relationships between markets and economic variables are flawed since the relationships can alter according to the situations. Dalio asserts that any fundamental approach should be broad enough to adapt to disparate environments. He also states that it is extremely essential to learn from one's mistakes since it allows an individual to learn the pain of loss and improve himself. It also provides a path to adjust his strategies according to the new situation. If you make a mistake in trading, you must modify and use that as a reminder in the future.

Chapter 3: Larry Benedict

Larry Benedict, a trader who has had several failures, doesn't even use charts while trading. He trades in oil, currency, gold, futures and S&P, and instead of depending on formulas to trade anything, he does it on the basis of discretion. Basically, he views the markets with respect to the price action rather than in isolation since markets are actually correlated and these correlations can change drastically over time.

He states that the price action involved in other markets could contain vital information but a trader needs to hone his skills and develop his strategies based on his own experiences. Benedict swears by extreme risk management that contains two important aspects. First, he limits his portfolio risk to about 2.0 to 2.5% before mitigating any further losses. A trader should accept the loss and simply move on. Second, when he approaches the threshold, he reduces the position size and trades smaller until he sees any profit. This kind of risk may be very difficult for other traders but it can be implemented to avoid huge losses. He says that a trader should behave like a risk manager and minimize his losses if he's ever stuck in a losing trade.

Chapter 4: Scott Ramsey

Scott Ramsey, a trader who trades the FX and futures, is an individual who believes in taking low risks. He states that traders who are technically oriented can make huge profits when coupled with a key fundamental approach since understanding the fundamentals helps a trader determine the direction of the market. With his intuitive ability, Ramsey is known to combine his analytical skills with a fundamental approach to gain best results.

In addition, Ramsey always purchases the best markets in a sector for long positions while selling the weakest ones in a sector for short positions. Novice traders typically do the opposite but are exposed to huge risks. Generally, he will limit his risks to only about 0.1% on every trade, thus ensuring that the losses on new trades are meager. Although this tactic might not be feasible for other traders, the concept of utilizing close stops on new trades while allowing wide stops after the profit margins could work for many traders. He also says that it's extremely important for a trader to be intuitive and develop it as a skill over time.

Chapter 5: Jaffray Woodruff

Jaffray Woodruff, a futures trader, believes in doing things differently. Some traders – also known as CTAs – utilize techniques that follow trends and others use countertrend techniques, but Woodruff comes in the third category where his approaches doesn't seek to make profits from trends. The system is designed in such a way that it identifies higher profits for lower or higher prices over a short term. Woodruff, along with the help of the computerized trading systems, has become extremely successful today and remarks that his father's advice to evaluate one's own performance has helped him succeed. He also stresses the importance of looking where others actually don't – a trading rule he lives by – and also urges traders to keep note of their transaction costs.

Chapter 6: Edward Thorp

If you're a trader, you've probably wondered about whether the markets can be beaten. As a response to this question, people who believe in the Efficient Market Hypothesis, also known as EMH, state that it's not possible unless you're lucky. According to the monkey argument theory, if you have countless monkeys typing randomly on a computer, one of them will eventually type "Hamlet", but obviously you will need hundreds or thousands of monkeys to achieve this. Similarly, proponents of EMH will say that if you have enough traders, a few of them will perform brilliantly simply by chance. However, if this analogy is to be believed, then all trades are simply a matter of chance, which is extremely unlikely. So how many traders would one need to achieve outstanding records, you ask? Thorpe's track record, 227 successful months of trading out of 230 months of trying, answers the question because his record statistically proves that it is definitely possible to beat the market.

According to Thorp, investing and gambling is similar since they are both based on probability. Thorp applied mathematical analysis and scientific knowledge and defied standard preconceptions with his book, "Beat the Dealer", thereby forcing casinos to alter the way they operated. After being kicked out, he looked for a new place where he could still beat the game but not risk a bloody nose. No surprise, he fell into trading securities. He further states that it's possible to achieve the impossible if the problem is approached from a different perspective. Thorp also traded warrants for years using an equivalent formula detailed in the Black-Scholes model before it was even published!

Chapter 7: Jamie Mai

Jamie Mai, the founder of Cornwall Capital works on several strategies, but one characteristic that's shared by all the strategies is that they are structured as highly asymmetric, where the upside potential of the trades exceeds downside risks. Mai's short bet on the subprime mortgages made him famous as a character in Michael Lewis's "The Big Short" book.

Mai's strategy is based on five key principles:

- Find mispricing – Mai seeks opportunities to trade that arise due to prices because they are based on assumptions that could be inappropriate for the current market situation. An out of the money option is a good example of this.
- Select trades that reflect a positive outcome – Cornwall only selects trades where the gains when multiplied with the positive outcome are about twice as large as the loss when multiplied with a probability of negative outcomes.
- Asymmetrical trades – Although Mai has a very concentrated portfolio, the asymmetric structure of his trades ensures that the downside is limited with an open ended upside if he ever goes wrong. One can achieve this by buying options, but it should be done only when there is a mispricing.
- Wait until the trade he seeks comes along – Mai waits with patience and conducts trades only on the ones that meet his guidelines.
- Utilization of cash for targeting portfolio risks – Mai typically holds about 50 to 80% cash in his portfolio since most trades are derivatives that need smaller cash expenditures.

Chapter 8: Michael Platt

Michael Platt, the co-founder of BlueCrest, a hedge fund firm that has over \$29 billion in assets and 400 employees started trading stocks when he was just 13 years old. More than anything, the firm focuses on risk control and has an outstanding record with minimal losses since its inception. Platt says that he can't stand losing money and stresses the importance of risk control that's vital for traders.

For Platt, risk management starts with the implementation of trades. He implements trades in such a way that it minimizes losses when compared to the same potential of return. He seldom implements trade ideas as short or long positions but will use complex structures or long options that offer constrained risks with an equivalent potential of return. In addition, he also adjusts his positions every day and will immediately get out of the trade if he feels uncomfortable. He says that he steps out of a position if he didn't want to purchase the security at that price. Further, he remarks that traders should follow the 80/20 rule, where 80% of one's profits should be derived from 20% of trades. Interestingly, Platt declares that he'd rather prefer a poker player rather than an analyst when hiring a trader, simply because the poker player recognizes the edge.

Chapter 9: Steve Clark

Steve Clark is the founder of the Omni Global Fund that has consistently generated remarkable profits ever since it was founded in 2011. Clark is an individual who speaks his mind and has sound advice for traders when he says that they should always stick to what works for them. For instance, if you're a trader who's adept at long term positions, you should stick to it instead of experimenting with short term trades where you lack experience.

There are many traders who deviate from their comfort zone and regardless of whether they do it because of boredom or overconfidence, it is risky. Clark states that they should first identify where they shine and then focus on those trades. In addition, he says that traders should only trade with what they're comfortable with because as the position becomes larger, the trader is under a lot more danger of making decisions based on emotions and fear instead of relying on his judgment. Most successful traders are one-trick-ponies and stick to what they do best because if they deviate from that, a disaster is inevitable. It's also important to take a break and remove yourself physically from a negative environment when you're losing trades. For Steve Clark the market will always tell you whether you are right or wrong.

Chapter 10: Martin Taylor

Martin Taylor is the founder of Nevsky Fund, a hedge fund firm that was launched right in the midst of a bear market, but that hasn't stopped him from making enormous profits. He admits that it's not possible for him to take extreme positions, especially when he's managing somebody else's money. Therefore, when the market is up, he tries to capture about 70 to 80% but when it's down, he tries to lose only 30 or 40% of it.

Furthermore, he declares that his largest position is Apple since it's almost analyzed solely by analysts in the US. These analysts seem to think that the company's potential to grow is limited by the US market; however they fail to identify the fact that while the US has only about 300 million people, there about 6.7 billion people all over the world. For instance, Apple is performing the best in China that has over 900 million subscribers for cell phones and they have sold about 3 million phones there. In addition, he believes that Apple will repeat its history of success it has enjoyed in the US, all over the globe. Many investors shy away from Apple mainly because the prices have shot up, but according to Taylor the prices are actually cheap, based on his projection of earnings. It's important to note that Martin was talking about Apple back in 2012.

Chapter 11: Tom Claugus

Tom Claugus, the CEO of the hedge fund firm GMT, manages about \$5 billion in assets. After working for 15 years at a chemical company, he decided to quit and take up his passion – stock trading. As a natural contrarian who tends to make large profits when others are losing, Claugus says that a trader should alter his exposure according to the opportunities.

He also says that a trader shouldn't make the mistake of judging whether a trade was right or wrong, depending on its outcome. One should accept the fact that it is possible to lose money even when strategies are well planned out because the market situations fluctuate drastically. For instance, a coin toss with 2:1 odds might seem like a losing bet, but when it's made repeatedly it could turn out to be highly profitable. On the other hand, many winning trades could also be termed as poor decisions when they fail over the long term. It is possible to make money on individual trades with poor trading choices; however, if it's done consistently, it could be a disaster over time.

Chapter 12: Joe Vidich

Joe Vidich is the founder of the Manapalan fund that was launched in 2001. Amazingly, the fund has had a net return of about 18%, which is exceptional for a company that survived two major bullish markets that took place from 2001 to 2011. He says that a trader shouldn't worry about being 100% every time. Each and every trader faces his worst fears when the market moves against his position. Even when the trader is aware that his position is dangerous, he continues to hold on to his position. According to Vidich, a trader, when faced with this dilemma, can liquidate a part of his position and take a partial loss, instead of liquidating his entire position. The trader can continue to liquidate if the situations don't change and this ensures the loss is minimal.

He also stresses that it's important to limit the position size or it's very likely that a trader's decisions are based on emotions and fear, instead of sound judgment. In addition, he says that the best way to manage risk is to evaluate a position consistently. It's imperative for a trader to not consider that he's right and it can also be tough to sell stocks when they are going down as it can be emotionally difficult. To cope with the distress Vidich suggests that a trader can sell a percentage of the stock and always be comfortable.

Chapter 13: Kevin Daly

Daly performs more like a private investigator than a manager of hedge funds. Within 12 years, he has managed to make gross returns of about 800% and he says that this incredible success has been possible because of his small asset size. Daly only manages about \$50 million in his firm, Five Corners, and this small size allows him to get a taste of a lot of more opportunities when compared to firms that manage billions of dollars.

Individual investors might not appreciate the company for dealing only with small sized assets; however, Daly has no interest in raising additional assets because his investors can vary their positions with no impact. He states that he has seen managers performing well with limited assets, but he also seen them fail when they tried to build additional assets that was beyond their optimal level. He further adds that it is important for a trader to follow a strict discipline and not add more assets if they believe that it will hamper their performance. More assets can restrain the investor from investing in smaller issues. Most importantly, he focuses only on companies he is familiar with, as Warren Buffet calls it, the “Circle of Competence”.

Chapter 14: Jimmy Balodimas

Jimmy Balodimas, a man who breaks all rules, is known to be fearless. He goes against the tide and considering the fact that he sells into the uptrends while buying into the downtrends, his successful journey in the stock market is very enigmatic. For one, he doesn't get influenced by the actions of the other people in the market and two, he doesn't worry about whether he's right or wrong. Jimmy Balodimas is in it to make money, period. Moreover, he doesn't panic and sell stocks like other traders who are driven by emotions. Interestingly, Jack Schwager's son works for Jimmy.

Chapter 15: Joel Greenblatt

Joel Greenblatt, the author of, *You Can Be a Stock Market Genius*, and, *The Little Book That Beats the Market*, shut down his fund, Gotham Capital, although the compounded return was a staggering 50%. In fact, Greenblatt states that he had to close the fund because it was performing so well. Once the assets grew big enough, they began impeding the returns and that's when he decided to return the investors' money.

Greenblatt hired a programmer in 2003 to check if the two metrics he used, worked in the markets today. When the combined metrics worked even better than he had imagined, he named it the “Magic Formula” and set it up on a website to manage stock portfolios. His approach is modeled after Warren Buffet's ideology and he also believes in the value investing method. He says that value investing works in the long run, but it doesn't always work in the short run. Some investor can't stand the insecurity and volatility that is related to his style of investing, especially if results are not good for a few years.

Conclusion: 40 key lessons

This book is amazing for anyone who wants to dig deeper into how the wizards in the hedge fund business perform. Jack Schwager has provided a gist of all the lessons offered by the successful people interviewed in this book and here are a few:

- There is no holy grail or single solution when it comes to trading
- Do what you're comfortable with
- Do not mistake losing and winning money with bad and good trades
- Develop your own trading method that fits your true personality

- Be flexible and adapt to the constant changes of rules in the market
- Always look for an infinite upside and minimal downside in all trades

The list of 40 lessons goes on and Schwager outlines all the key points necessary for a novice to understand how investments work. Readers looking to develop their own trading skills will certainly have a lot to chew on over this book!

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