AN END TO THE BULL
CUT THROUGH THE NOISE TO DEVELOP A SUSTAINABLE TRADING CAREER
GARY NORDEN
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About the Author

Gary Norden started his trading career at the age of just 18, trading equity derivatives for a Japanese investment house. He was the youngest ever trader in that firm’s history.

Gary went on to enjoy a successful career as a trader in the City of London. At the age of 23 he became head of LIFFE options for NatWest Markets and he later held senior trading positions at Credit Lyonnais Rouse and ING Financial Markets.

Gary has also spent many years trading futures and options with his own capital, both in the trading pits of LIFFE and on computerised markets.

Since moving to Australia in 2003 Gary has developed an international reputation as a financial markets consultant, trading mentor and author.

Gary’s first book, *Technical Analysis and the Active Trader*, was published in 2005 and exposes technical analysis as little more than poorly performing rules of thumb. The book was also translated into Chinese and Korean.

Gary has written for publications and websites around the world, including Your Trading Edge, Stocks and Commodities, www.trade2win.com and www.bullbearings.co.uk.

Gary has a reputation for challenging assumptions and thinking outside the box. He is driven by a love of trading and a desire to help new traders gain access to a more professional standard of information and education. Gary pulls no punches in his attacks on
the parts of the financial industry that he believes lead traders down
the wrong path.

2014 marks 25 years since Gary started his trading career. For
more information on Gary, visit www.organicfinancialgroup.com.
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INTRODUCTION

‘Stocks are going up.’

At first reading I would suspect that most readers would not have an issue with that statement. It’s quite common for us to hear such claims, and most of us would have made similar statements during our trading lives.

But what does it really mean? Does it mean that all stocks will go up? Surely not, as even during bull markets some stocks will fall. The reality of markets is that some stocks rise and some fall each and every day. Reducing this action to a simple generalisation is lazy, and poor analysis. What if the overall stock market does go up but other assets or inflation rise further? In that instance those who bought stocks may actually have lost out.

There is an incredible amount of bullshit in this business. (I will call it ‘noise’ from now on.) Despite huge progress in the understanding of trader psychology and decision making, noise is still prominent in the trading and investing industry. There are a number of reasons for this (as I explain in chapter 1) but most relate back to the domination of the media by brokers and analysts, instead of traders. Currently most retail traders are, unsurprisingly, confused by all the noise and they too often end up following unreliable analysis.

In my first book, Technical Analysis and the Active Trader, I exposed the flaws of technical analysis, one of the most widely used forms of analysis in the business. I showed that chart patterns, moving averages and other technical tools are unreliable and result in losses
for the majority of traders who use them. In this book I will expose a number of other trading myths, some of which have become accepted wisdom. Unfortunately our business is infested with myths, and trying to overturn them is no easy feat.

To me, the statement ‘Stocks are going up’ is akin to saying ‘Cars are fast’. Some cars are and some are not—and it can also depend on what we are comparing them to. Compared to horses, cars are fast—but compared to aeroplanes, they aren’t.

Would you buy a car from, or value the advice of, someone who makes statements such as ‘Cars are fast’? Yet in this business, each and every day, traders are listening to and acting upon claims from such people. Here is my first piece of advice: ignore ‘experts’ who make generalisations such as ‘stocks are going up’ or ‘stocks are cheap’ and ‘stock XYZ is going to $10’—they are unlikely to be traders; they will be sell-side individuals. Traders tend to speak differently, weighing up various risks, and the world seems a lot greyer to them (as opposed to black and white).

However, as I explain in chapter 1, most people prefer to hear simple, clear statements, whether they are valid or not. Ask a decent trader what direction stocks are heading and the answer will include an analysis of risk, a separation of different sectors or classes of shares and a discussion of various outcomes. That is why traders make lousy brokers—most retail traders and investors would think that such a response shows weakness because they have been led to believe that ‘real experts’ can make clear, simple forecasts. This is wrong, and is one of the many beliefs that many readers will need to unlearn.

There will be many views in this book that you may find hard to accept at first reading; at times you may even feel uncomfortable because I will challenge some of your current views and expectations. I have become used to that reaction from some sections of the trading community, particularly technical analysis–based traders. When I was presenting to a group of traders following the release of my first book I was met with the statement, ‘But what you’re telling us is completely different from what everyone else is saying’. My reply was blunt: ‘The majority of traders lose money, so I’m quite happy to be different from them.’
In that sentence is the essence of this book. To succeed as a trader you will need to break free from the herd and be comfortable making your own decisions. There is no comfort in doing what everyone else does and failing with them. If you are someone who likes doing what others are doing, then you should reconsider trading.

As I have said on many occasions, the day that the analysis and trading techniques that I use become the norm for most retail traders is the day that I stop trading. If that sounds at odds with the fact that I have written this book, the reality is that I know it is unlikely that this book will ever become the accepted blueprint for most retail traders, as it requires too much independence of mind and resistance to accepted wisdom. In the same way that I knew that when *Technical Analysis and the Active Trader* was published, no matter how unreliable I showed technical analysis to be, it would continue to be widely used.

My aim when trading is to make good decisions based on the information at hand, and that is what I would encourage readers to learn to do. I rarely try to make predictions of future price movement. (To quote Yogi Berra, ‘I never make predictions, especially about the future’.)

I would imagine this sounds odd to many readers; accepted wisdom is that traders are trying to forecast the future prices of financial contracts. However, there is a lot more to trading than that simplistic view. We need to weigh up various risks and alternative outcomes, incorporating the potential magnitude of moves as well as the probability. I will examine and explain these ideas later on.

Short cuts in trading are typically short cuts to failure. I realise that many retail traders are time-poor, with high expectations of success, but I’m not here to tell you what you want to hear—I will tell you what you need to hear. That will differentiate me from most writers and, as stated before, I’m comfortable with that.

Trading is a difficult business involving decision making that humans have not evolved to cope well with. Sometimes there will not even be a ‘right’ decision; it can depend on your risk tolerance. It is important, though, to make decisions based on sound information and to cut through the noise. I hope to show you how to do that.
Many trading courses and books teach a style of trading that involves finding an indicator that ‘works’ and then applying that to your chosen market. This is a simplistic way to trade. It’s like a golfer only using a seven-iron; no matter how good he gets at using it, there will be times when his club can’t help him. My suggestion is that we embrace as many different techniques as possible so that we can try to find the right trade for the right market condition. Market conditions change, and we need to be able to adapt our trading accordingly.

I should say that I do not claim to have ‘cracked’ this business or to be some kind of ‘superstar’ trader. I started my trading career at the age of 18 and have enjoyed more than two decades as a trader. Trading is the only career that I have known and it has been good to me, but I write this book as much as an observer as a trader. By that I refer to the many traders that I have seen fail, and the extensive research that behavioural psychologists and economists have uncovered over the past twenty years or so. This exciting research tells us a lot about our tendency to look for short cuts in our decision making, and our inability to make sound judgements. We need to learn from these studies, and I will endeavour to show what types of decisions and analysis are dangerous and ways to overcome them.

I would also encourage you to read Fooled by Randomness and The Black Swan by Nassim Nicholas Taleb. They remain, in my opinion, the best books about trading and this business in general.

This is not a ‘How to trade like Gary Norden’ book; the ideas and techniques I suggest are used by many professional traders, but they have not permeated through to the retail sector, due to the domination of the sell side. It is also important to state that I do not consider the ideas and techniques set out in this book to be set in stone. I am always looking for ways to improve my analysis and decision making, always looking at new behavioural research to help me understand what biases or short cuts I may be using. It is vital for all of us to constantly re-evaluate our techniques and make improvements where necessary. Don’t ever think, ‘That’s it, I’ve made it!’ because, as I have seen on many occasions, the market has a way of taking from those who are overconfident.
The ideas and strategies laid out in this book represent what I understand and believe to be valid at this time; if and when new ideas come to light, then I will be more than happy to revisit my ideas and make adjustments. Again, I hope that readers understand (or learn to understand) that it is not a weakness for us to state that we do not know everything and have scope for improvement. Many great thinkers, including John Maynard Keynes and George Soros, have been criticised for changing their views. However, as I will explain, changing our mind can be a strength, not a weakness—if supported by a change of facts.

I will show that it is actually crucial for traders to seek information that conflicts with their views rather than supports them—if this sounds odd now, it should become clear later. Again, this is all part of the significant difference between the ideas that I present and those you will almost certainly have read elsewhere.

At all times I will endeavour to explain why I use a certain strategy or technique so that you can understand the thinking behind it. Time-poor retail traders often want a simple trading plan or technique that they can simply deploy time and again; that is not the approach I use or teach, and if you are serious about trading you shouldn’t either. To have a chance of enjoying a sustainable career you will need to understand what lies behind the technique or trade, so that you can learn from mistakes and improve your analysis and trading.

Humans are prone to short cuts when making trading decisions, and I will explain what those short cuts are and what you need to do to try and overcome them. This is one area that for some will be easier said than done.

I recognise that an increasing number of traders are favouring an automated approach and, while this book is aimed primarily at manual traders, there are still many lessons for automated traders to learn. In particular they will need to find ways to incorporate concepts such as pricing in into their trading. Each market is different and, no matter what or how we trade, our techniques will need to include an understanding of how our market works.

Finally, I must state again for the record that I do not believe that everyone can become a successful trader. It should be possible
for many people to improve their techniques and decision making, but I doubt whether most can enjoy sustained profitability; there are simply too many psychological weaknesses to overcome.

The analogy that I use is golf. I know that, no matter how many golf lessons I have, I do not possess the ability to become a professional golfer. Even if Tiger Woods or Adam Scott were to teach me, this would probably not affect my ability to become a professional who performs in front of thousands of people. Sure, they should be able to help me improve my game and tell me the key ingredients of a good swing and getting the club into the right position, but being successful at golf is more than simply understanding what to do; it’s having the ability to do that under pressure. There are many scratch golfers in the world, but how many can earn a good, sustainable living from golf? My guess is less than 1 per cent.

Daniel Kahneman, Nobel laureate and expert on behavioural psychology, is doubtful that we have the potential to control the biases that weaken our decision making. While I will show some techniques that will help you if implemented correctly, from experience I know that some people just struggle to continually make good decisions. Facing up to losses and cutting losing trades in particular is one area that many people struggle with, no matter how many times they are told to do so.

I hope that all readers will take something from this book. For those of you who have the potential to become successful traders, I hope that I can point you in the right direction and help you avoid the avoidable pitfalls that afflict so many. For those of you who may decide that trading is not for you, hopefully this book will save you from losing substantial sums to the financial junk-food industry—if that’s the case, it’s still a worthwhile read.

Trading is a great challenge and I wish you well on your journey. As always I welcome all feedback and endeavour to reply to all emails.

Best regards,
Gary Norden
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Part I

The need for change

In the first part of this book I investigate some of the problems and pitfalls that beset traders. Some are self-inflicted, while others are the result of poor advice and unreliable suggestions from a sector of the financial world that I describe as the ‘financial junk-food industry’.

In order to begin our journey to a more sustainable trading career, we first need to understand the pitfalls that we will come across so that we can navigate through them and eventually learn to ignore them completely.

I show that we are all prone to using short cuts, which can help us in other areas of our life—but, unfortunately, they will hurt our trading. I explain these short cuts and, as we progress through the book, I continue to show ways to try to overcome them. Our focus should be to make sound decisions based on real information.
Chapter 1

The financial junk-food industry

In this chapter …

I explain some of the reasons why retail traders can be led in the wrong direction and end up employing unreliable analysis and trading techniques. There is a strong element of mythbusting in this chapter, and no doubt I will offend some in the industry with my views. I am not easing readers in; from the outset I will be confronting you by challenging widely held assumptions and views.

Traders play a different role from brokers and analysts

During my time as a convertible bond trader I received an email from a salesperson from a large US investment bank. The email contained a research piece about a convertible bond that his firm was recommending; the piece ran to a number of pages, and it looked comprehensive. Skimming through the research I disagreed with some of the assumptions that were underlying the analyst’s view that
the bonds were cheap. Later that morning I received a call from the salesperson asking what I thought of the trade idea, and whether I would like to buy any of the bonds. My first question was, ‘Do you have any of the bonds or will you need to go to the market to buy them?’ His answer was that his firm had $10 million of the bonds on their books, ready to sell.

I now had all the information I needed to decline the trade. Here is what had probably happened: another trader sold $10 million of these bonds to this US bank, or the bank had them on its trading book. The bank then decided to sell these on because they didn’t want them on their own trading book. This is usually because they believe the bonds are too expensive. An analyst was then tasked with preparing a research piece advocating the cheapness of the bonds, which required the inclusion of some dubious assumptions. The brokers could then go out and sell the bonds. This is often how the sell side works.

In my writing I use the terms ‘buy side’ and ‘sell side’. I would expect that for many readers it’s the first time they have heard of or read those terms. In the professional industry (investment banks, hedge funds and so on) they are commonly used and well-understood terms but, as with many other aspects of the professional trading business, this knowledge is not evident among retail traders. So my first task is to explain what they mean and why it’s important for you to understand the difference between them. Once you do, much of the rest of this chapter, and perhaps this book in general, will be clearer.

**Sell side**

It is probably easier to start by looking at the sell side. The sell side of the industry is tasked with selling products such as shares and bonds. The two most common jobs on the sell side are brokers and analysts. Investment bank desks have a third position: salespeople who are in effect institutional brokers who sell to hedge funds, managed funds, and so on.

It’s very important to understand that brokers and analysts are employed to sell; they construct stories, research papers and