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Trading PSYCHOLOGY 2.0

FROM BEST PRACTICES TO BEST PROCESSES

BRETT N. STEENBARGER

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Trading Psychology 2.0

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EPIGRAPH

If you don't have time to do it right, when will you have time to do it over?

John Wooden

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PREFACE

Successful efforts to master markets lead us down paths of self-mastery. This book is one guide to those paths.

Market participants have traditionally defined self-mastery as *discipline*—controlling the emotions that all too often distort information processing and trigger impulsive behavior. To be sure, discipline is required for any great undertaking, whether it is pursuing an Olympic medal, a business startup, or a medical breakthrough. But discipline, while necessary for success, is never sufficient. Discipline does not substitute for skill, talent, and insight. Strict, disciplined adherence to mediocre plans can only lock in mediocre results. If it were otherwise, there would be no losing automated trading systems.

I've followed and traded markets since the late 1970s. During the past decade, I have served as a full-time performance coach at two trading firms—Kingstree Trading in Chicago and Tudor Investment Corp. in Greenwich, Connecticut—and worked with many other trading organizations on a consultative basis. Through the TraderFeed blog and three prior trading books, I've had the honor of interacting with thousands of traders around the world. If there's one thing this whirlwind of experience has taught me, it's that there is far more to market mastery than controlling emotions and impulses. Sustained success requires the cultivation of a host of positive performance elements: creativity, productivity, adaptation to change, and psychological well-being. The good news is that recent research in psychology and related fields has profoundly deepened our understanding of these contributors to human performance. The bad news is that most of us in the money management world, immersed in the day-to-day challenges of keeping up with news flows and market movements, have little opportunity to sift through and apply this knowledge. As a consequence, we tend to work hard, but not smart. From the organization of our daily routines to our reviews of performance, we rarely optimize learning, independent thought, and productivity.

The unfortunate tendency to substitute quantity of effort for quality ensures that we will face a yawning gap between our real and ideal selves: between who we are and who we're capable of becoming. *Trading Psychology 2.0* seeks to bridge that gap by breaking trading success down to four essential processes. In the coming pages, you will learn a simple ABCD:

A How to dynamically Adapt to changing market conditions
B How to identify and Build on your distinctive trading strengths
C How to Cultivate creative processes and generate fresh market perspectives
D How to Develop best practices that help you sustain productivity and effectiveness in your work routines

Most of all, this book is about taking best practices—the ingredients of your trading success—and weaving them into best processes. The goal is not to change you but to help you more consistently tap into the drivers of your success.

In hindsight, it's not difficult to see that *Trading Psychology 2.0* is a natural extension of my previous books. The first of these, *The Psychology of Trading*, focused on the emotional problems faced by traders and how these mirror common life challenges. It introduced a solution-focused framework to trading: identifying the patterns that underlie our success and becoming more consistent in enacting those. My second book, *Enhancing Trader Performance*, adopted a developmental view of trading success, emphasizing expertise development as an ongoing process of deliberate practice that matches skills, talents, and challenges. An important implication of that work was that there are many forms of trading, each requiring unique skills and learning processes. I continue to find that many of the emotional problems faced by developing traders are the result of bolting generic learning processes onto very specific performance domains, creating frustration and suboptimal performance. Finally, my most recent text, *The Daily Trading Coach*, created a cookbook of psychological techniques and approaches to help traders overcome common performance challenges. An overarching theme of that book is that a primary goal of trading psychology is self-coaching. By becoming better self-observers and catching best and worst practices as they occur, we can overcome market noise with enhanced self-determination.

Trading Psychology 2.0 differs from these books in one key respect: It breaks trading success down into those four ABCD processes and explores research-based ways of maximizing them in our personal and professional lives. The book's aim is to move trading psychology beyond the usual focus on discipline, emotional control, and trading one's plans to the broader context of sustaining peak performance. Most important, the book aims to nudge traders toward what might be called meta-processes: robust routines for changing our routines and adapting trading to ever-changing market conditions.

It is not enough to find an "edge" in financial markets; as any tech entrepreneur can attest, competitive advantages are perishable commodities. Those who sustain success continually renew themselves, uncovering fresh sources of competitive advantage. That requires processes for assessing and challenging our most basic assumptions and practices. It takes a good trader to create success, a great one to recreate it. Nothing is quite as difficult—and rewarding—as letting go of what once worked, returning to the humble status of student, and arising phoenix-like from performance ashes.

What makes any performance domain worthy is that none of us will ever completely master it. There is always room for improvement in dance or golf; chess players, brewmasters, woodworkers, and racecar teams can always hone their craft. For that reason, performance activities are the consummate psychological crucible, moving us ever closer to self-mastery. This is particularly the case with trading, where the rules of the game continually evolve. What other field demands the utmost of conviction and risk-taking, but also the greatest of flexibility and prudence? In adapting to change, we embrace change, we become change. We cannot rest on individual best practices; we need *best processes* that yield ever-improved practice. There will always be a gap between real and ideal: between who we are and who we can become. If this book can be a resource in bridging your gap, it truly will have fulfilled its aim.

Of course, no performance journey is traveled solo. Life is a team sport and success crucially depends on surrounding yourself with the right teammates. I owe many debts of gratitude to colleagues at Graham Capital, Tudor Investment Corp., Kingstree Trading, and SMB Capital;

the ever-resourceful editorial staff at Wiley; Victor Niederhoffer and the Spec Listers; and Howard Lindzon and the supportive crew at Stock Twits. The book wouldn't be possible without the many talented traders who contributed best practices and inspired the case studies. As in my prior books, the names and identities of the traders in those case studies have been changed to preserve privacy, but I want my debt to the many fine people I work with to be as publicly voiced as possible. The greatest debt, however, is to the family that has offered constant love and support through all the not-so-constant financial markets: Debi, Steve, Laura, Devon, and Macrae; their families; and most of all to my wife, Margie. She, not markets, has been the love of my life, and that has kept me sane through many ups and downs in the business. Finally, to the many readers of the TraderFeed blog a hearty thank-you for your support and all you've taught me. I think you'll find many of those lessons in the pages that follow.

INTRODUCTION

There is a valuable tradition in academic scholarship called the literature review. A literature review is a survey of published research on a given topic, with an eye toward identifying what is known and what remains to be investigated. A good literature review is selective—covering the most important, methodologically sound studies—and it is integrative, highlighting areas of consensus and debate within a research field. Without such efforts, science would generate far more data than understanding. At its best, the literature review is a bridge between observation and explanation. If undertaken properly, it illuminates existing research directions and inspires new ones.

Although the exercise that inspired this book was a performance review and not a literature review, the aim was similar. I identified approximately a dozen of the very best traders I had worked with intimately over a decade of coaching and asked myself what made them tick. On the surface, they were quite different. Some were daytraders in the electronic futures markets; others were portfolio managers in currency and fixed income markets. A few were highly quantitative; others drew on pattern recognition in a purely discretionary manner. Some were outgoing, some introverted; some were highly emotional and passionate about winning and losing; others were relatively calm, cool performers.

When I looked at what these traders did, all I found was variety. When I examined *how* they did what they did, however—the processes underlying their decisions and actions—several common features leaped out at me:

- *Adaptability*. To a person, the best traders were adaptive and flexible. They were sensitive to market environments and altered their trading to fit changing landscapes. Often, they would quickly alter their risk exposure, sensitive to occasions when market action did and did not confirm their expectations. Even more broadly, they adapted to changing market regimes by learning new skills, broadening their trading universe, and reworking their analytics. What made them successful was not merely that they possessed a trading "edge." Rather, they had found ways of continually honing and expanding that edge.
- *Creativity*. The ideal for any trading firm is assembling a group of traders, each of whom delivers superior risk-adjusted returns in a relatively uncorrelated manner. Thanks to the power of diversification, that provides the business with a relatively smooth equity curve and allows it to leverage its capital effectively. Wherever I've seen successful trading firms, I've encountered creative traders: ones who view markets uniquely, find original ways to generate ideas, and express their views in fresh ways that maximize reward relative to risk. Indeed, I would venture to say that I have never known an extraordinarily successful trader who was not extraordinarily original in his or her approach to markets. I refer to such traders as "idea factories," as they develop robust routines for detecting opportunity where others see none.
- *Productivity*. My experience confirms the findings of Dean Keith Simonton's seminal work on greatness: The elite performers generate better ideas because they generate so many ideas. Their hit rate is not necessarily unusually high, but they go to bat so often that they get their share of good pitches and hit their fair share of home runs. Knowing that their strength is processing information and generating ideas—not just holding any particular idea—they are willing to toss aside less promising trades and hold out for truly exemplary ones. This productivity is readily apparent on a day-to-day, week-to-week basis: The greats simply get more done than their colleagues. They organize their time and prioritize their activities so that they are both efficient (get a lot done per unit of time) and effective (get the right things done). How much time do we typically waste as traders, staring unthinkingly at screens, chatting with people who offer little insight,

and reading low-priority/information-poor emails and reports? The successful traders invariably are workhorses, not showhorses: They get their hands dirty rooting through data and make active use of well-cultivated information networks. They realize that higher-quality inputs will yield superior outputs.

- *Self-management*. I can think of few vocations that blend risk and uncertainty in as immediate way as trading. In many lines of work, good enough is good enough: Slipups are rarely irreversible or fatal. In financial markets, good enough is the expected, the average; it's not what produces outstanding results. Maintaining focus, optimism, and energy level during periods of drawdown is not easy. Nor is it easy to attend to life's many responsibilities when focused on fast-moving markets. Successful athletes realize that only very high levels of conditioning will allow them to deliver their very best performance. For traders, the conditioning is cognitive as well as emotional. Successful traders I've known work as hard on themselves as on markets. They develop routines for keeping themselves in ideal states for making trading decisions, often by optimizing their lives outside of markets.

Working with traders on a full-time basis, immersed in the daily realities of trading performance, has provided me with a front-row perspective on trading success. My overarching conclusion from years of coaching effort is that what makes traders good are best practices—sound methods for deploying capital and managing risk. What makes traders *great* are best processes: detailed routines that turn best practices into consistent habits. Adaptability, creativity, productivity, and self-management: These aren't just things that the best traders have. *They are what best traders* ***do***—*routinely*.

The most important review you can conduct is not one of the research literature, but of yourself. If you place your best trading under a microscope, you'll initiate your own review and the chances are good that you'll observe how you best adapt to change, innovate, stay productive, and manage yourself. It is difficult for us to appreciate—especially during times of drawdown—that at some times, in some ways, we already are the traders we hope to become. Our task, in markets as in life, is to uncover the practices and processes that enable us to more consistently tap into the best within us.

Very few challenges are as noble or rewarding as fully becoming who you are at your best. Let the journey begin!

Brett Steenbarger

PRELUDE

I'm not sure when I first focused on the fact that time is an event. There are many events that help us define time, from the Earth's daily rotation to the radiation emitted by cesium atoms. We mark time with such events as birthdays and anniversaries; we think of a year in seasons and holidays. Waking up, eating, going to work, coming home, taking vacations—we live life in event time.

Suppose I am an athlete and my energy level is a function of when and how I practice and perform. Sometimes I practice daily; sometimes I take a day off; sometimes I practice very intensively; sometimes less so. If you were to chart my energy level over time, you'd see irregular ups and downs—seemingly no pattern at all. But suppose you defined time in terms of performance events. Suddenly we would have a new chart—a new *x*-axis—and regularities would become apparent.

It is November 10, 2014. I am in my kitchen, sitting at the center island, accompanied by the youngest of our four rescue cats, Mia Bella. I have just finished overhauling my market charts, removing time from the *x*-axes and replacing it with an event clock. Examining past markets, I find striking regularities—ones I had never seen before. Soon I will see if those regularities provide actionable insights in real time.

I've had interesting market ideas in the past. This one feels different, however. It feels like opening an animal crate that has been transported from a rural Kentucky high-kill shelter, picking up the soft, gray, purring kitten, and knowing this is the one.

Someone in the crate area watched Mia cling to my shoulder and commented, "She's chosen you." That's the way it is with all great things, whether they be life companions, career callings, or paradigm-shifting ideas: *They choose you*.

But you have to be ready to be selected . . . .

Best Process #1: Adapting to Change

It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change.

Charles Darwin

Emil's Restaurant

Emil is a chef who purchased a restaurant in a prosperous suburb. The restaurant had not been making money for the past few years despite having a broad menu, a friendly owner, and good standing in the community. The young couples that flocked to the suburb because of its superior public education system, convenient shopping, and low crime rate wanted something other than a traditional, sit-down restaurant. They desired a bit of the city life: a lively venue for eating, drinking, meeting friends, and socializing. The old restaurant was just … too … old … and the owner could not keep pace with shifting diner tastes. So he sold the place to Emil.

Emil spoke with the new area residents to learn more about what they wanted in a restaurant. What he heard was that they wanted "fresh": fresh food, a fresh look, fresh music. He asked them to name some of their favorite urban hangouts, and then he visited the establishments. What he found was large bar areas with long tables, so that people could mix and mingle easily and share their "small plates." Few people at those establishments sat down for large entrees and multicourse meals. Rather, it was all about grazing and drinking and mixing with people in an upbeat environment.

Emil recognized that the market had changed. What used to bring in customers no longer was attractive. A growing portion of the dining population desired a social experience, not just a quiet, well-prepared meal. They enjoyed moving around and trying different foods, not sitting and feasting on a single main dish. Creative drinks and lively contemporary sounds were an important part of the experience. The new diners wanted more than the usual background music and traditional beverage selection. They loved upbeat electronic sounds, inventive mixed drinks, craft beers, exotic soft drinks, and a broad selection of unique wines from quality vineyards.

So Emil rebuilt the business. In place of the heavy wooden dining tables and chairs, he purchased modular, colorful seating that could be quickly arranged and rearranged to create a variety of environments, from open bar to sit-down brunch. Gone were the traditional pictures on the walls, replaced by soft, streaming lights that illuminated exotic woods, stone, and glass block. Cutting-edge music videos played on large, hi-def screens, amplified by a high-quality sound system. A fresh website, Twitter feed, and Facebook page alerted diners to the day's upcoming dishes. A photoset of dishes being served was uploaded each day to Instagram and linked to other social media.

Those, however, were not Emil's most radical changes. He decided not to change the old restaurant's menu, but to do away with menus altogether. In place of the traditional fixed menu supplemented with a few "daily specials," Emil committed to making every dish fresh every day, based on ingredients he could source that morning in local markets. If Emil and staff found a superior catch of fresh fish, excellent cuts of dry-aged beef, and several local fruits and herbs, the evening's dishes featured combinations of those ingredients. Each day, he and his kitchen team created an entirely new menu. The slogan beneath the restaurant logo said it all: "A different restaurant every day."

Freed from the constraints of a menu, Emil enabled his customers to order from tablets distributed by the wait staff. Now patrons could read detailed descriptions of each dish and its ingredients, enter their orders electronically, and send orders immediately to the kitchen. The tablets were readily available throughout meals, so that diners could order fresh drinks and even share comments about what they liked best and least. Those comments helped subsequent customers make their choices. Diners especially liked reading about suggestions for pairing dishes and beverages. As the comment base grew, the ordering system became a kind of internal social media site, where dining ideas were crowdsourced and regulars developed reputations for their food and drink reviews.

The greatest power of the ordering system was that it created a database for Emil. Over time, he learned what diners liked and didn't like. He discovered that younger males liked different drink/dish combinations than women in their mid-30s. He learned how couples ordered differently from single patrons; he found that the descriptions and pictures of dishes greatly influenced their popularity. Female customers preferred poultry and fish dishes to ones with red meat; older diners looked for quiet tables and several course meals; customers who ordered the most mixed drinks were also the ones who ordered the most specialty coffee beverages. Gradually, the database helped Emil understand which dishes to emphasize and which to eliminate. He created a different restaurant experience on weekend evenings than weekday afternoons: different food, different layout, and different music. Armed with continuous data from customers, he rapidly adapted to shifting tastes.

And the customers? They loved the up-tempo music, the clean modern lines of the décor, and the "cool" ordering app. The website gained traffic; Twitter followers and Facebook friends exploded: There was a buzz about Emil's restaurant. Were there setbacks? Of course. A customer dropped his tablet and shattered the screen. That led to new protective devices for each "menu." A few inebriated customers wrote inappropriate comments in their reviews, so Emil instituted greater monitoring of entries. Several older customers, befuddled by the newfangled electronic instrument on their table, needed to be coached on how to operate the tablet. That led to simple step-by-step instructions displayed on table tents throughout the restaurant. Each problem led to a fix, and each fix gave Emil an opportunity to show customers he cared.

Best of all, Emil was able to hire a superior kitchen and waitstaff, as people wanted to be part of this cutting-edge venture. He announced sizable bonuses for staff members who generated unique ideas implemented in the restaurant. One waiter suggested that the app could also take people's music requests, so that staff could play diners' favorite tunes during their visits. A junior chef further suggested archiving all the music choices, so that the database included the music selections for customers who completed a profile. Then, when each customer made a dining reservation, his or her favorite tunes were automatically added to the evening's playlist.

What Emil recognized is that adapting to changing markets means being willing to change who you are and what you do. The new restaurant embodied new practices (playing customers' favorite music), but also new processes (electronic ordering informed by crowdsourcing). In redefining dining's social dimensions, Emil created truly fresh experiences for customers and a distinctive "edge" in the marketplace. Thanks to a deep database tracking orders and preferences, he ensured that, in Darwin's terms, he was the "most adaptable to change."

Emil could only accomplish that, however, by embracing change. "A different restaurant every day" became both a challenge and mission. Staying fresh—never static—was the key to success. Instead of structuring the restaurant the way he wanted, Emil let the customers define the experience. His motto wasn't "If you build it, they will come." Rather, he figured out what made people come and built his restaurant around that.

The Single Greatest Barrier to Adaptation

By now you have figured out the relevance of Emil's restaurant for trading financial markets. As traders, we have ideas about how to generate returns from markets. Some of those ideas exploit macroeconomic trends or company fundamentals. Others draw their inspiration from technical patterns or carefully tested relationships among predictors and market outcomes. *Rarely, however, do market participants develop explicit processes for adapting to changing markets*. In that respect, we are like chefs who think that if we keep preparing good dishes, customers will forever line our doors. The failure to adapt to shifting markets manifests itself in sadly tone-deaf spectacles: portfolio managers chasing macroeconomic themes in markets dominated by the effects of positioning and sentiment; momentum traders playing for breakouts in low-volatility, rangebound markets; money managers adding to risk on "diversified" portfolios even as correlations and volatilities ramp higher.

In each of these cases, the result is frustration and potential emotional interference with future decision making. *The root cause of the frustration, however, is logical, not psychological*: It is the natural consequence of failing to adapt to a changing world. The restaurant owner who sold to Emil was probably frustrated with the business, but that is not why success eluded him. He was a good owner; he did what made diners happy. Unfortunately, he kept doing it long after a new kind of diner had entered the scene.

To be sure, there are traders with discipline problems and poor impulse control. There are also traders who act out unresolved emotional conflicts in markets, with predictably tragic results. But successful money managers do not suddenly morph into emotional basket cases. When we see mature professionals act out of frustration, ready—like the restaurant owner—to give up the business, there's a high likelihood that this is a failure of evolution, not merely a failure of psyche.

Key Takeaway

Emotional disruptions of trading provide information, often signaling the need to adapt to changing markets.

So why don't bright, successful professionals adapt? Why don't we, like Emil, embrace change and the stimulating challenges of renewal? Too often, the answer is ego: Once we are attached to a given reality, it becomes difficult to embrace another.

The previous restaurant owner *believed* in his menu. He was passionate about his cooking and customer service. And that passionate belief killed his business. He became so attached to—so identified with—his business model that he could not construct an alternative. He didn't *want* to become a different restaurant every day. He wanted customers to flock to the restaurant *he* believed was best.

Therein lies a considerable dilemma. Entrepreneurs need deep, enduring belief in their businesses to weather the arduous startup process. It is that belief that cements a company culture and attracts talent committed to the firm's mission. That same belief, however, can imprison us. It becomes difficult to embrace change when your very heart and soul are wedded to what you are doing. Ironically, the more committed we are to what we do, the more challenging it becomes to make the changes needed to stay ahead. Think of key innovations in the world of technology—rarely have those sprung from the industry giants. The mainframe computer makers were not those who pioneered the personal computer market; the personal computer makers were not those who popularized tablets and smart phones; social media has arisen more from startups than established software firms. Paradoxically, success can harbor the seeds of its own undoing once innovation becomes status quo.

■ ■ ■

A dramatic illustration of the difficulties of adapting to change can be found in a research study conducted in 1945 by Karl Duncker. He posed a problem to subjects in the study, showing them a corkboard wall, a box of tacks, a candle, a table, and a book of matches. The challenge was to use these resources to attach the candle to the wall in such a way that it would not drip on the table when lit. Subjects typically tried a variety of solutions, from trying to tack the candle to the wall to lighting the candle and sticking it to the wall with the drying wax. None of these solutions worked; none guaranteed that the lit candle wouldn't drip on the tabletop. The correct solution was to take the tacks out of the box, put the candle in the box, tack the box onto the wall, and then light the candle. People struggled with the problem, Duncker suggested, because of what he called functional fixedness. They were so accustomed to seeing the box as a container for tacks that they failed to envision its use as a candle holder. They were trapped, it seemed, in their mental sets.

Now here's the interesting part: Subjects facing the exact same candle problem *but initially shown the tacks outside of their box* had a much easier time solving the problem. Once the box was separated from its contents, it was not difficult for the study participants to perceive alternate uses for the box. Instead of seeing it as a container for tacks, they perceived it as an empty box. With a different perceptual frame, subjects were no longer functionally fixed and could shift their mental set and solve the seemingly unsolvable.

In our story of Emil the chef, it's clear that he succeeded, not by improving the old restaurant, but by shifting his mental set and redefining the concept of restaurant. The functionally fixed previous owner might have tried a host of menu and décor changes to no avail. As long as he stuck with the old definition of restaurant, he was bound to thwart the desires of the new generation of diners.

Emotional fixedness fuels functional fixedness. When we identify with a way of trading or a kind of analysis, we not only can't perceive alternatives: *We typically don't want to see them*. Many years ago, I spoke with an equity long/short money manager who was struggling with performance. He viewed himself as a master stock picker based on his ability to identify value that was underpriced by the market. This value orientation made him a contrarian: He liked good companies that were unloved by the Street. The problem was that unloved companies often became more unloved before the market awarded them the expected premium. The stock that was a great buy 20 percent off its highs became a burden to the portfolio once it was 35 percent below its peak. That led to agonizing decisions about selling good companies at bargain prices versus holding losers and risking poor performance and investor redemptions.

I suggested to the manager that his dilemma might be addressed by creating a relatively straightforward money flow filter for the names in his book. I showed him how each transaction in each stock occurred either nearer to the best bid price at the time or the best offer. This execution information, summed over time, could provide a useful indication of the degree to which buyers or sellers were accumulating or distributing their shares with urgency. By waiting to size up positions in his fundamentally strong stocks until they were showing early signs of accumulation, the manager could potentially limit his drawdowns and more effectively leverage his bets.

The manager looked at me in total shock. It was as if I had suggested that he solve his domestic problems by initiating an extramarital affair. "But I'm a stock picker," he explained. "That's what I do best. If I start doing something different, I'll never succeed." For him, stocks traded on fundamentals like boxes hold tacks. He was functionally and emotionally fixed: Any analysis that did not pertain to company fundamentals was suspect. From my perspective, a money flow filter for his risk exposure could have made him a more effective fundamental stock picker, just as the social focus made Emil a better restaurateur. But our manager did not want to track money flows and refine his entry execution; he wanted to outsmart the market and find unrecognized value. In a very important sense, he was looking for self-validation, not profit maximization. And that is a powerful barrier to adaptive change.

The Power of Flexible Commitment

Antti Ilmanen's *Expected Returns* text is noteworthy for its conceptual framework. In the book, he breaks markets down into "building blocks" and explains returns in terms of the interplay of these drivers. As an active trader, I look at different building blocks than Ilmanen, but the structural approach is similar. Starting with the vast array of technical indicators in the literature, I identify a small, low-correlated set of potential market drivers and assess which are influencing price action during the most recent, stable market period. Basic to this approach is the notion of *regimes*: What drives price during one period is not what moves markets at other times. When I place a trade, I'm not simply betting that the market will rise or fall: I am also making the key assumption that the stable (stationary) regime that has defined the most recent past will persist into the immediate future.

For example, in the regime for equity indexes that has been dominant during my writing of this chapter, sentiment and positioning have been statistically significant drivers of prospective price action. When equity put/call option ratios have been high and we've seen rises in cross-sector volatility and correlations, we've tended to see bounces in the S&P 500 Index futures. Conversely, low put/call ratios and modest volatility and correlations have led to inferior returns in the index. During other market periods, sentiment and positioning have not been so important to market returns. Factors such as momentum and market breadth have been far more valuable as market predictors. As Ilmanen notes, the drivers of price action change over time. A successful investor finds tools that capture a range of drivers and thereby harvests profits across market regimes.

There are many ways of understanding and assessing market regimes. John Ehlers, who is well known for his MESA work on market cycles, defines the time series of any asset as the result of a linear (trend) component and a cyclical (mean-reverting) component. To the extent that a market is dominated by its linear component, we want to behave as trend-followers. To the extent that a market is dominated by its cyclical component, we want to fade both strength and weakness. Success is not to be found in being either a *momentum* or a *mean-reversion* trader; perennial bulls and bears eventually meet with grief. Rather, the key to trading success lies in flexibility—the ability to adapt one's trading to shifting market environments—just as Emil adapted to the altered dining environment.

An important implication of this line of thought is that, once we define ourselves as one kind of trader, we sow the seeds of our undoing. If we identify ourselves as trend followers, we leave ourselves vulnerable to frustration in low-volatility, rangy markets. If we identify ourselves as faders of market extremes, we open ourselves to getting run over by strong momentum moves. When a market approaches the top or bottom of a range, the strategy that had made money in the cycling environment can now lead to ruin in a breakout mode.

Key Takeaway

The short life cycles of market regimes ensure that successful traders will be the fastest to adapt to changing market conditions.

This, for me as a psychologist, has been one of the greatest surprises working with professional money managers: The majority of traders fail, not because they lack needed psychological resources but because they cannot adapt to what Victor Niederhoffer refers to as "ever-changing cycles." Their frustration is a result of their rigid trading, not the primary cause. No psychological exercises, in and of themselves, will turn business around for the big-box retailer that fails to adapt to online shopping or the gaming company that ignores virtual reality. The discipline of sticking to one's knitting is destined for failure if it is not accompanied by equally rigorous processes that ensure adaptive change.

But how can we be passionately committed to what we're doing in the present and equally committed to leaving it behind as the winds of change begin to swirl?

■ ■ ■

When Chris and Gina came to my office to work on their marriage, they showed few signs of being a dysfunctional couple. They spoke in calm, even tones and did not engage in any of the bickering or defensiveness commonly seen among troubled couples. Nevertheless, they were seriously contemplating a breakup. The theme they came back to time and again was that they had grown apart. It wasn't the presence of any great conflict that led them to think about separating; rather, it was the absence of the bond they had once experienced deeply. As much as anything, they wanted to know: Where had it gone?

"Love doesn't die," the saying goes, "it has to be killed." In the case of Chris and Gina, however, it was difficult to find a murder weapon or even any murderous intent. Both were devoted to their children and household; both held jobs they liked. "We're a great team," Chris explained, "we have good times on vacations and no one could be better with the kids than Gina. But it just seems that something is missing. We don't go out like we used to, we don't do things with friends. We don't have *fun*; there's no spark. It's just not the same as it used to be."

I watched Gina closely as Chris spoke. It seemed she was uncomfortable with what he was saying, but she did not speak. Twice, she turned her head as if in deep thought and looked away from her husband. Finally, curiosity got the better of me and I asked Gina what she was thinking about. She looked a bit embarrassed and explained, "I just remembered that the kids' soccer practice was moved to the weekend." She turned to Chris, "We're going to have to get my car back from the garage.

I'll need it to take the kids tomorrow morning." Chris didn't miss a beat. He excused himself, whipped out his phone, and dialed the repair shop to make sure they didn't close early on Friday.

Like they said, they were a great team. And I had one helluva difficult counseling case.

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It turns out that one of the most challenging periods for couples occurs when children first leave the home. Why is that? On the surface, the empty nest sounds appealing: ample time to socialize, pursue recreational interests, and travel! For couples who have poured themselves into family life, however, the return to couplehood can be difficult. The shared, daily focus on children is now lost. If there is nothing to replace it, suddenly there's no shared focus. Couples who thrive during such a transition are those who define and embrace new lives for themselves. They retain deep family ties, but now within a broader context of personal and joint social, recreational, and career interests. They sustain prior commitments even as they flexibly adopt new ones.

If you were to look closely, you would see that the most successful couples had already begun aspects of their new lives during their mature parenting years. As the children became older and more self-sufficient, the spouses began doing more things together and individually. They were not threatened by the developmental change in the family. Indeed, they anticipated and embraced it. The successful couples planted the seeds for their future.

The same is true of successful businesses. Firms that thrive nurture a pipeline of new products and services while they are committed to making the most of existing offerings. An automobile manufacturer readies the next generation of electric vehicles while still selling traditional gasoline-powered and hybrid units. A pharmaceutical firm knows that best-selling drugs will eventually go off-patent and conducts the research to find the next blockbusters. A baseball club scouts new talent at the same time it does all it can to maximize its current lineup.

We can only master the future if we embrace the fact that the present is temporary. To paraphrase Ayn Rand, successful people and organizations fight for the future by living in it today. For them, change poses a stimulating challenge, not an onerous ego threat. They pour themselves into their commitments even as they flexibly build fresh ones. That is because they create bridges from the old commitments to the new ones.