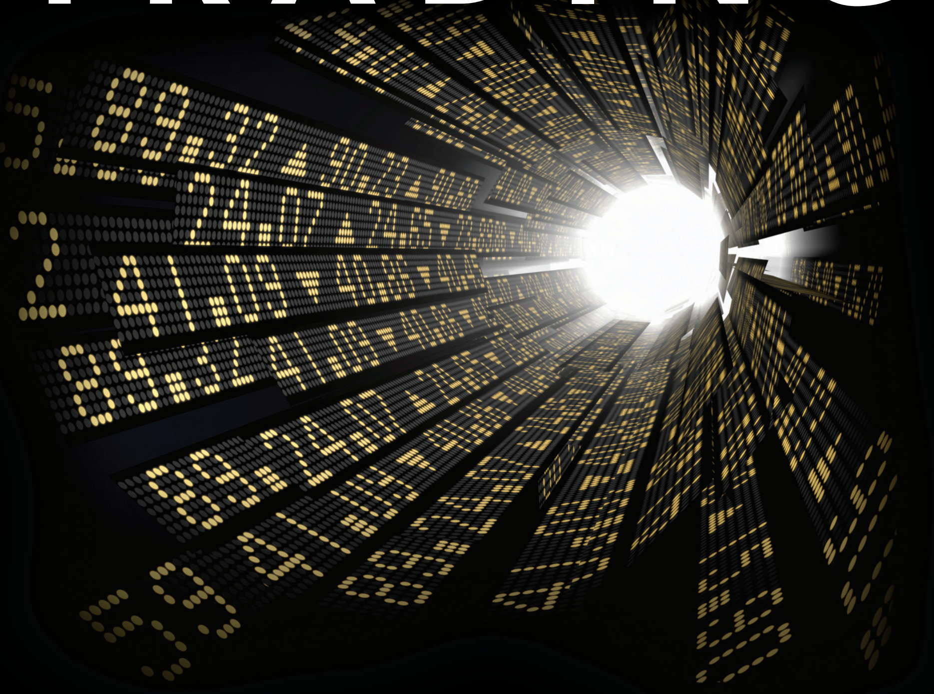
MICHAEL MARTIN

FOREWORD BY ED SEYKOTA

THE INNER VOICE OF TRADING



ELIMINATE THE NOISE, AND PROFIT FROM THE STRATEGIES THAT ARE RIGHT FOR YOU

Praise for
The Inner Voice of Trading

"Michael Martin has written an insightful book for both the expert and novice. His writing style is enjoyable, and the content is unforgettable."

—Anthony Scaramucci, Founder, SkyBridge Capital, and Author of *Goodbye Gordon Gekko*

"I live by Michael Martin's words. The first chapter of my investing book was titled 'Turn Off the TV.' Now, with the social web, finding strategy mentors and learning faster are all possible. Trading is a skill you can learn, and Martin's book is a great read for any trader."

—Howard Lindzon, Founder, StockTwits

"In *The Inner Voice of Trading*, Michael Martin recounts his own quest to become a successful trader, illuminating his journey with engaging trading episodes. Join Martin at his trading desk as he provides important insights into the art and science of balancing thoughts and feelings—and catching the big one."

—Ed Seykota

"Some people trade and either don't or can't teach; some people teach and have never traded; Michael Martin can teach extremely well and is an experienced trader. This rare combo is a necessity to those who want to succeed in the markets. Read and learn!"

—Victor Sperandeo, Founder, Alpha Financial Technologies, LLC

"*The Inner Voice of Trading* provides insights that may help both discretionary and systematic traders adhere to their extensively researched and tested trading programs and be better insulated from their occasional emotional (fear, greed, pride, and so on) temptations to deviate into uncharted waters."

—Bill Dunn, DUNN Capital Management

"Michael Martin provides a toolbox to fortify the most important aspect of successful trading: the six inches between your ears. With fresh insights from many of the market's greatest traders, *The Inner Voice of Trading* will put you on the path to improving your profits and losses."

—John Del Vecchio, Portfolio Manager, AdvisorShares Active Bear ETF

"Too many new and developing traders move from strategy to strategy in the hope of improving their under performance. In *The Inner Voice of Trading*, Michael Martin helps us understand how we first must work on ourselves before we can become the trader we want to be. Find a place in your trading library for this latest gift to the trading community."

—Mike Bellafiore, Partner, SMB Capital, and Author of *One Good Trade*

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The Inner Voice of Trading

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The Inner Voice of Trading

Eliminate the Noise, and Profit from the Strategies That Are Right for You

Michael Martin

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Dedicated to my parents,
Robert J. Martin and
Anne M. Martin

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Foreword

Michael Martin's book, *The Inner Voice of Trading*, provides important insights about the art and science of balancing thoughts and feelings in trading.

Traders tell wonderful stories about making phenomenal profits by being in the zone, at one with the markets, living in the moment of now. From there, trading seems effortless. The trick, then, is to stay in the now. If you get impatient or greedy or fearful, you can break the spell and wind up back in the past and future. Fighting your feelings can be anathema to staying in the moment, hence to trading profitably.

In *The Inner Voice of Trading*, Martin extends the literature on the art and science of staying clear and maintaining mental and emotional balance. He uses examples from his own trading and others' to illustrate his points—particularly the importance of timely surrender.

Traders know the essential principles of trading: ride your winners; cut your losers; manage your risk; use stops; stick to your system and ignore the news. These principles work well in trading and in life in general—when you follow them consistently. Many people, however, find that following rules is not always a whole lot of fun.

Living a principle-centric life takes character—lots of it. Buying highs, selling lows, and collecting seemingly endless strings of whipsaws may bring up unbearably uncomfortable feelings. Martin deals directly with the important character-success connection and illustrates the topic by wrapping it in a series of engaging trading episodes.

One of the pleasures of mentoring traders through my Trading Tribe® is that I get to meet, interact with, and share experiences with bright and willing people—and to watch them grow and prosper. And that brings me to one Mr. Michael Martin who, many moons ago, joins my Tribe.

At first I see an east-coast, street-wise hyper-mensch, a cross between a crusty old cabbie and a stand-up comic. As the group evolves, I witness his emergence as a brother who comes to feel deeply and laugh and wince and cry and grieve along with the rest of us as we all struggle with the personal calculus of our careers and intimate relationships.

Over the course of our association I have the privilege of witnessing a softening of Michael—as he becomes more porous, stronger, and more available to share his gifts with others. Reading between the lines of *Inner Voice*, I feel that Michael is still very much a man of the path and that he is now coming into his own as a generous teacher, mentor, and writer. I see him as a big inspiration for the new crop.

It is my honor to accept Michael Martin's invitation to pen this forward to his book. I congratulate him for writing it—and you for reading it.

Ed Seykota

Austin, Texas

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As far as the publishing of this book is concerned, I owe a special thank you to my Executive Editor Jim Boyd who believed in the vision for this book from the get-go. Jim introduced me to Russ Hall as well as uber-author Michael Thomsett who were instrumental for their keen insight and suggestions. I am grateful for the staggering amount of time that Jim, Russ, and Michael spent reviewing the evolving manuscript.

About the Author

Michael Martin has been a successful trader for over 20 years. He's been teaching for the last 13 of those years through UCLA Extension and the New York Society of Security Analysts (NYSSA), a member society of the CFA Institute. During that time, he also served as Associate Editor at *Trader Monthly*. He was born and raised in New York and now lives in Los Angeles.

He contributes to *The Huffington Post*, *The Business Insider*, and his blog MartinKronicle.com. He has also been published in Barron's.

His interest in trading commodities began as a student, both in the classroom and at work. It was during a random work-study program that he got introduced to creating seasonal models for Heating Oil and Natural Gas for a large hedger using Lotus 123.

That led to working on Wall Street and trading commodity accounts. The commissions were gigantic, but he figured he could earn several times more by earning an incentive fee. After only 3 years at a brokerage firm, he started his own company.

After moving to Los Angeles from Manhattan, he started his own CTA and also began teaching. Around that time he joined the Incline Village Trading Tribe and flew from Los Angeles to Lake Tahoe for meetings. He also formed the Trading Tribe in Los Angeles, for which he was Chief. Coincidence or not, he was ranked #1 by AutumnGold around that time.

His trading courses are available online and can be found at MartinKronicle.com.

Chapter 1

Introduction

Like many traders, I became very interested in trading professionally after I read Jack D. Schwager's book *Market Wizards,* a collection of interviews that he'd conducted with many successful traders and money managers at the time, such as Jim Rogers, Paul Tudor Jones, and Michael Marcus. Luckily for me, I was able to get to know and study with many of the traders interviewed. A few of them, such as Ed Seykota, became mentors and friends who had a profound impact on my psychological outlook while trading.

A lot of traders love the Seykota chapter in *Market Wizards* and can quote what might be his most famous line: "Win or lose, everyone gets what they want from the market." To this day, that line hits failing and mediocre traders right in their most vulnerable spot: If a trader is losing consistently, it is by design—it is the trader's goal. For Seykota and his students, intentions equal results.

"The goal for the trader is to develop a system with which he is compatible"—that is, a harmony between a trader's emotional constitution and trading technique.

However, I think that the most revealing thought in the chapter was another of Seykota's quotes: "The goal for the trader is to develop a system with which he is compatible"—that is, a harmony between a trader's emotional constitution and trading technique. In this case, a system is a set of rules for trading: what to buy, how much of it to own, when to get in, and when to get out, either to take a loss or to collect profits. These rules are intellectual in nature—at least, that's how they look from the outside.

Lurking below the surface are the emotional buttons they push when the trader employs them. The intellectual aspect of trading rules are what most aspiring traders reach for while learning the craft because they've had that approach ingrained in them since kindergarten. Unfortunately, most aspiring traders find out far too late that the act of trading is 20% intellectual and 80% psychological. I hope to change that with this book.

When Seykota was being interviewed, he was not speaking about rules "that [the trader] can understand intellectually or technically"—he wasn't offering a "how to trade" proposition. He instead referred to rules "with which [the trader] is compatible," an emotional and self-awareness proposition. Compatibility equals harmony.

Incompatibility between trader and system is the single greatest reason most traders don't succeed, regardless of trading style. They have no emotional connection to their trading rules and methodology. They know trading rules from a technical and intellectual standpoint, but not from a psychological or self-awareness one. Not all of this is their fault, though: Our educational system generally is not concerned with how its students feel about anything—there's no room for it. This rote, mechanical model sets up the trader for failure before he knows that he wants to be a trader. Admittedly, it can be challenging to know who to turn to for this type of awakening. In unfortunate cases, the trader is not self-aware but continues to seek the answers. Ironically, these answers to successful trading are found within the trader's own mind.

Incompatibility between trader and system is the single greatest reason most traders don't succeed, regardless of trading style. They have no emotional connection to their trading rules and methodology. They know trading rules from a technical and intellectual standpoint, but not from a psychological or self-awareness one.

To trade successfully, your intellect and psychology must be joined at the hip. Like spouses in a marriage, both intellect and self-awareness evolve. If the self-aware spouse checks out, maintaining a lasting marriage is difficult. The situation puts stress on both spouses. If one partner needs time "to figure out who he is," a trial separation is best, to keep the trader from vaporizing the cash. A trader without self-awareness in trading is like a pilot trying to fly a plane with no navigator.

Trading rules are provocative and evocative, pushing and pulling a trader emotionally. "Should I get in at this price?" "Should I buy some of this stock?" "Should I get out here and take a loss, or should I wait for it to come back?" For me, these are not intellectual questions—they are emotional. What the trader is feeling at the time evokes the question. Think about what the trader is conveying emotionally, because it's rarely about the money.

> Question: "Should I get in at this price? Is now a good time to buy?"
>
> Emotional translation: "I have no idea what I'm doing, but I'm going to do it anyway."
>
> Question: "Should I buy some of this stock?"
>
> Emotional translation: "I want in on the action. Just tell me what to do, and I'll do it—but make it quick. Having so much cash is painful."

According to Jason Zweig,[1] having the potential for gains is more addictive than earning the gains themselves.

> Question: "Should I take the loss now, or wait for it to come back?"
>
> Emotional translation: "What will everyone think? I have an MBA, and all my self-esteem is invested in how smart I think I am. I am not willing to risk this. This is who I am. If I wait, I'm technically not wrong. I can defer my incorrectness and maintain my self-esteem today."

Traders are human beings first, so it follows that everything we do is part of our overall tendency to seek pleasure and avoid pain. Both are omnipresent for traders and investors alike. In each of these hypothetical questions, clearly more is being conveyed than the "how to" part of trading. Frankly, the "how to" is the easy part. When the self-awareness part betrays the "how to" part because traders don't have the skill to feel emotions and understand what they are saying, only trouble

For traders who lack harmony between technique and self-awareness, the voice they hear comes from the most antagonistic person in their life.

can come from it. If you get into this situation, along with all the colorful emotional knots you'll feel in your body, you'll have a black-and-white version in your profit and loss statement.

A trader doesn't need another person to ask these questions, nor to answer them. For traders who lack harmony between technique and self-awareness, the voice they hear comes from the most antagonistic person in their life: "You should have become a doctor! I told you that this trading nonsense is legalized gambling." However, once they achieve a harmony between technical rules and self-awareness, they discover an inner calm and a sense of confidence. When this occurs, they hold conversations with what I call their *inner voice*. This is the one voice that the "market wizards" developed and learned to listen to exclusively.

The heart and soul of this book examines trading decisions from an emotional standpoint and helps you gain insight into your behavior. In the process, you will evolve from listening to the cacophony of conformist and conventional wisdom, to speaking with and listening to your *inner voice*. The journey involves getting to know yourself and increasing your level of self-awareness. How much you learn about yourself is limited only by which feelings you are *not* willing to feel.

The longer you attended school, the more ingrained the "how to" approach is in your learning model and your "accuracy model" of keeping score. You may be used to thinking along these lines: "If I get 90+% of the questions correct, I'll get an A on the exam. If I do that several times in a row, I'll get an A for the class." Accuracy and correctness become the goals. Nowhere is the concept of self-awareness addressed verbally or literally, but it is expressed in others' behavior at home and in your social circle, based on how others act with you and around you.

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This situation works in trading as well. Before you became a trader, you may have gone to college for your MBA. You may have opted to achieve one of the most difficult professional designations: the CFA (Chartered Financial Analyst). Your parents likely are proud of you, and you're proud of yourself—and you should be. You clearly have more education than most of your peers and most of the world. But despite all your demonstrable intelligence and wisdom, you may still have trouble executing the single most important tool in your trading arsenal: keeping your losses small. The reason is simple: Smart people don't like being wrong. You've built your whole life on living the life of success. It's more comfortable because that's what you're used to. As a trader, you'd rather stay in a losing position and wait for the market to prove your thesis correct than take one of many consistent small losses.

Social mores are hard at work, too. They create conflict between trading profitably and your tendency to desire accuracy in all your endeavors. It feels better to strive to be correct than to face defeat. In this case, the banal mantra of "Winners never quit" doesn't serve you in managing risk—and that's what traders are, risk managers. Winners never quit, but quitters have more equity in their accounts when they admit defeat and return tomorrow with a fresh start and a clear head. They are not distracted by having to wait on their emotional front porches for some losing position to come home profitably.

It's not that you don't get it, but you're not emotionally able to reconcile how smart you are with the emotional-based behavior that you think you must execute in the trading profession if you want to compete. It's not about making gains alone (a game of pure accuracy)—it's about consistently making less frequent gains that are several times the size of the losses (a game of mathematical expectation). Professional traders approach taking risks according to the concept of mathematical expectation which addresses the provocative nature of traders being wrong more than 50% of the time (not accurate), yet be wildly profitable, and most importantly, emotionally placated throughout the trading process. Understanding mathematical expectation can help bridge the chasm between intellect and self-awareness. This is probably the single most important tool you have for developing your inner voice. Consider an example.

Imagine the following rates of return for five equally weighted positions in a hypothetical portfolio, Scenario A:

Position 1	+25%
Position 2	+10%
Position 3	Flat, neither gain nor loss
Position 4	–10%
Position 5	–25%

For all the hard work in putting this portfolio together, the overall return is flat. Positions 1 and 2 indicate skill or luck, and positions 4 and 5 indicate lack of skill or bad luck. But because all the positions are the same size, the overall rate of return for the portfolio is zero. Many traders further complicate matters by selling positions 1 and 2 and leaving positions 3, 4, and 5 to see if they will come back. That's the equivalent of pulling your flowers and letting your weeds bloom.

Now reconsider the same list two months later (Scenario B), with some risk management employed:

Position 1	+25%
Position 2	+10%
Position 3	Flat
Position 4	–10% (sold)
Position 5	–10% (sold)

Regardless of why positions 1 and 2 appreciated and positions 4 and 5 depreciated, they moved. In scenario B, because positions 4 and 5 were eliminated before depreciating further, the portfolio achieved an overall rate of return of +3%—and no one knows whether it was due to skill or luck. Taking losses in positions 4 and 5 involves self-discipline and surrender. These are emotional and self-awareness concerns, not intellectual ones. By employing this self-awareness and discipline in a portfolio and keeping losses small, both experts and dart-throwers perform better. After selling the losers, Portfolio B is 60% invested and has 40% in cash. Winners thrive in this environment. If this trader has an evolved inner voice, he doesn't waste energy wondering about the losing positions. He thinks clearly and focuses on taking the next steps, adding to the winners, and taking on new positions. His portfolio is in harmony with his head. His positions and his portfolio are compatible with his goals. They are making money. As a trader, your gains will look like gains in your overall profit and loss statement when you keep your losses small.

In addition, these positions don't care what you think about them. Imagine that position 4 or 5 was Apple stock, and perhaps you have an emotional attachment to the security because of your fondness for the company's products or its CEO. Apple is not a person with feelings, and it doesn't have a "red phone" with a direct line to Steve Jobs so that you can tell him that you own the stock because you think he is an incredible genius. Apple has no idea that you even own its stock in your portfolio, especially if you own it in street name. To develop your inner voice, you need to see Apple solely as a vehicle for you to capture the forces of supply and demand, regardless of the length of time you own it. The minute you become emotionally attached to a stock, you lose the rational ability to keep your losses small. You've become emotionally invested in the outcome.

If this were my portfolio, I would have also sold position 3. If a security has not moved in either direction after two months, I sell. When you purchase a security, only three things can happen: It goes up, down, or sideways. In two of the three scenarios, I am wrong. It doesn't matter whether I lost money—I am wrong. Traders refer to this type of liquidation as a "time stop," offsetting a position after ample time has transpired and the security has not produced any profits.

Some traders look for stocks and trading ideas to hotwire their portfolios because they see trading as a process of singling out tomorrow's headlines before they make the news. A magazine could publish just one issue per year with the headline "Keep Your Losses to a Minimum of –10% of Your Net Capital." They would go a great distance in defeating financial illiteracy, but financial literacy is not their business. They're in the business of selling magazines and keeping ad rates high. When you develop your inner voice, you can see things more clearly and laugh like I do when I see headlines such as "CMGI Is the Berkshire Hathaway of the Internet" or "10 Stocks the Pros Are Buying Now." With or without funny magazine covers, trading is a process that focuses on keeping losses small. Focus on that process, not the outcome.

> In my experience, when a new position goes against you, it usually keeps going down. Good trades start making you money right away.

The little trader in your brain may be asking, "What happens if I get out at –10% and it comes back?" Emotional translation: "What happens if I feel frustrated and look stupid at the same time?" If you're asking yourself these questions, you may be emotionally tied to the name of the company and your educational level. Furthermore, when you're first starting out, you're likely to feel one of two different things about a trade. You feel the first if you sell at a –10% loss; you feel the other if you let the position continue to bleed to –50% of its original value. You have a choice. When you listen to your inner trader, that choice is easy.

In my experience, when a new position goes against you, it usually keeps going down. Good trades start making you money right away. You can always get back in if you exit too soon. The takeaway is that you can never let a single losing trade wipe out any of your gains—they're hard enough to get in the first place. The next step is to explore your feelings about frustration or despondency and listen to what they tell you. Surrender and accept market movements, and feel a –10% move the same as you do a +25% one. By allowing yourself to feel frustration, you eliminate the feelings of despondency for the rest of your life. That's a great trade.

> By allowing yourself to feel frustration, you eliminate the feelings of despondency for the rest of your life. That's a great trade.

Your feelings are the true components of your trading rules and methodology, and the technical indicators you employ are more emotional validators than technical indicators. When you've fully developed your inner voice, you'll be able to say to yourself, "To be in the trades that make it to +25%, I need to emotionally endure trades that depreciate 10%." It's like saying that you can endure getting 5% of the questions wrong on the test and still get an A for the exam and the class. The outcome you seek is to make money overall—that is the A, in this case, even if you are incorrect on your trades more than 50% of the time.

Here's how I grade my students' behavior. I tell them that the day you can tell me that your best trade was a losing one, but one by which you acted consistently in your methodology, is the day that you are on to something. The day that you tell me that your best trade lost money and that you are emotionally placated is the day that that you start behaving like a professional trader. When you can do that for three years consistently, you will have become a professional trader. Ultimately, if you want to become a professional trader, you will want to understand mathematically and emotionally that trading losses are a part of the business. Make sure they're small.

I'm not the only person to believe that real goals, deep down, have nothing to do with trading and making money, but instead center on the emotional journey that trading will involve. Different trading systems evoke different emotional responses between genders, too. Women process their feelings better, but they don't like to compete head to head. Men love to compete, but they don't like to talk about their feelings. Women can bond and make friends in the ladies' undergarments section of a department store. Men, being men, would like to make friends with women in the ladies' undergarments section. Underwear, like stocks, can evoke strong emotional responses.

If you want to get a head start on developing your inner voice, start writing down in a journal all the feelings that surface for you when reading this book or in your trading. You need to keep a journal because you have to be hypervigilant about your behavior. How do you feel you are challenged intellectually? How do you feel when someone (like me) challenges something that you've held close for ages? You will learn about yourself with this exercise, and it will benefit your trading. Timothy Ferriss, author of *The 4-Hour Body,* has kept a journal of every workout he's done since the age of 18. He's in his thirties now. What you measure, you can improve. You can use a computer for a lot of trading, but you cannot delegate all your behavior to a computer. You need insight about yourself to develop your inner voice. If you haven't begun to trade yet, that's even better. Self-knowledge and self-awareness are your most important assets as a trader, more than any technical ability. You'll have an enormous edge on the competition if you focus on developing your self-awareness and then your inner voice.

I know what the little trader in your head is saying… "But Michael, I'm dying to start trading right now. I don't have any time for keeping a journal—I'm going to miss out on all these great trades. Plus, I want to be able to call myself a trader." No one cares if you become a trader. Become a trader for yourself, not to seek attention from other people. You've heard about the moth and the flame, right? Settle down and go read *Outliers,* by Malcolm Gladwell. If you're just beginning your career, you're just starting to log the first of the 10,000 hours that Gladwell says you'll need to become an expert, so you're in no hurry. You can write in your journal, "What are my feelings when I have to be patient?" Teach me what it feels like to be you when you have to be patient. Get to know these feelings, because they are likely to resurface in other areas of your life. One of the most important things I learned from Seykota is that the feelings you don't want have as much power over you in your trading as the ones you do want. The feelings you're avoiding might be dying to become your allies. You will go to great lengths to avoid certain feelings as much as you will want to "go toward the light" to feel the ones you think you want. Make sure that light is not a bug zapper.

If you become a professional trader, you will work hard for the rest of your life. What have you had to work hard for? How have you developed character? For traders, the most important work each day is preparation for the next day. This occurs somewhere between 5 PM and 10 PM each night. How do you feel about missing the Sunday night game of the week, *60 Minutes,* and *Monday Night Football*? You can always come back to your Fantasy Football league in a few years. Has missing *Dancing with the Stars* gotten you down? Great. That feeling is in the way of you working toward your goal of becoming a trader. Write those feelings in your journal, because they are part of your emotional system.

I once read a quote from Vladimir Nabokov: "A writer is someone for whom writing is more difficult than it is for other people." I was blown away by that insight, especially since I had read some of his books. How could a writer of his stature admit something with such candor? It hit me that Nabokov had a strong inner voice. His technical ability was married by his emotional constitution. After 23 years of trading, I understand where he was coming from. If there is an analogy to this in the world of trading, a trader is someone who has let go of the emotional need to be right all the time and has learned to love taking consistent small losses the majority of the time. He does not seek validation from his trades. He doesn't need advice from others, and he enjoys a personal discipline that very few have. He has married his technical knowledge with his feelings, and the resulting inner voice is his greatest asset and ally. This book attempts to shed light on how successful traders have come to this insight and what they had to do to obtain it.

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