A TURTLE MASTER'S
INSIGHTS ON THE ART OF THE TRADE

Curtis Faith
Original Turtle Trader & Bestselling Author of *Way of the Turtle*

TRADING FROM YOUR GUT

HOW TO USE RIGHT BRAIN INSTINCT & LEFT BRAIN SMARTS TO BECOME A MASTER TRADER

Foreword by **Van K. Tharp**
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Foreword

by Van K. Tharp, Ph.D.

If I had relied on my initial instinct, you might not be reading this Foreword. You see, intuition is a concept with which I am quite familiar. I have a Ph.D. in psychology with an emphasis on biological psychology, so the first few chapters of this book did not initially capture my interest. Those chapters, however, are a great starting point for traders without a psychological background. I would suggest you particularly focus on judgmental heuristics and how they influence trading because they are so important to trading decisions. Some other topics of particular interest are covered in the first chapters of the book: the differences between the right and left brain, group phenomena and how they influence trading, neural networks and intuition, and the dangers of intuition.

One point that Curtis makes and repeats again and again in this book is that you must train your instinct to get the best results. Because I agree with that, I kept on reading—and I'm glad I did. Chapters 6 through 8 blew me away. In this section, Curtis shows you how to train your brain to help you become an intuitive trader.

Usually, I consider a book worth reading if it helps me develop a major paradigm shift. When I read this section of the book, I came up with some fantastic ideas that will significantly help traders learn to trade better. For me, that kind of idea-generating inspiration is what makes *Trading from Your Gut* a great trading book.

The final chapters of the book cover some important and general ideas related to trading and intuition: 1) Issues with backtesting and intuition, including some novel ideas on how to determine if a

discretionary system is any good, 2) Balancing intuition and intellect, and 3) Living mastery.

Here's a quick look at different types of intuition and how my trader coaching experience has proven to me why intuition is invaluable.

Despite all of the advances in computers over the past 50 years, no computer comes close to a human brain. For example, I like to trade efficient stocks (stocks that trend with very little noise or random movement). A straight line going up at a 45-degree angle would be a perfect example of an efficient stock; however, I've never see one that looks that good. Most trending stocks show a lot of whipsaws, which I define as representing the amount of noise in the movement. The following graph is a fairly good example of an efficient stock. It's LQD, the long-term bond ETF, since last march. It just keeps going up with very little noise.

No matter how hard I've tried, it's been nearly impossible to program software that will give me a list of the most efficient stocks. The best I have been able to do is to compile a list of stocks to screen. I still have to look at the price chart of every stock to find the efficient ones. Anybody's brain can easily pick out an efficient stock

just by looking at it, whereas a computer cannot. Trading such visual price patterns is often called *discretionary trading*, and that's the first form of intuition.

The second form of intuition helps us with lots of data. The amount of information to which our brains are exposed just about doubles each year, especially since the advent of computers and the Internet. Your conscious mind, however, can handle only about seven chunks of information—plus or minus two chunks. To understand what that means, try this simple exercise. Have someone call out a long list of numbers while you have your hand raised. When you can no longer remember all the numbers called out, lower your hand. Unless you've mastered some advanced memory techniques, you probably will remember only about five to nine numbers—right in the range of normal human capacity. But what happens when you are exposed to thousands or even millions of chunks of information? You develop some judgmental heuristics (mental shortcuts) to cope. There are many famous heuristics that have been documented by psychologists over the past 20 years, and Curtis does a good job of documenting the role of these heuristics in trading.

A third form of intuition develops from thoroughly understanding a task and bringing lots of experience to it. Somehow, people with such experience do a superb job of sensing opportunity or danger quickly when no one else can imagine how they did it. Somehow, traders who have developed this kind of intuition just know that the market is about to turn down and can get out quickly. Alternatively, some can sense when a massive opportunity is about to occur. John Templeton, for example, used much of his fortune to short dotcoms at the beginning of 2000. Through the late 1990s, many were in agreement with Templeton basic logic: The dotcoms' business models did not merit their lofty stock prices. Applying that logic and shorting the dotcoms six months earlier, however, meant those

traders either had to cover their shorts at a loss or suffer through huge drawdowns. Templeton's timing was impeccable. How did he know when to short the dotcoms? Intuition. Similar feats have been accomplished by others in 1929, 1987, and at other major market turning points. The timing was absolutely amazing, and the only explanation for these feats is intuition.

In a more personal example, I worked through some deep psychological processes with a retired engineering professor in 1994. As a result of that work together, he connected with his internal guidance. Over the next 15 years that guidance directed him in many different directions, including trading. In 1994, he already had a substantial trading account but by mid-2008, he had grown it by 5100%. And then his guidance told him to stop trading—right before the 2008 market meltdown.

I spent some time with him in mid-2008, and he showed me exactly how he traded. In fact, it is surprisingly similar to my preference for efficient stocks. It was sound, logical, and very simple. He looked at the top five industry groups for long stocks and the bottom five industry groups for short stocks. The first step involved intuition. He could generally review a list of stocks and based upon volume, accumulation, and a few other variables, he could tell which charts from that group he needed to look at.

When he finished his initial screen, he looked at stock charts in two different timeframes: 1) a year's worth of daily bars and 2) 30 days worth of hourly bars. His charts included two simple moving averages, momentum, plus DMI+ and DMI-. He couldn't tell me exactly how he entered positions except to say that the price needed to be above both moving averages in both timeframes. I got the impression that he often looked for a short-term retracement in price to the short-term moving averages and then a bounce back.

When did he exit the position? My impression was that he exited when the price reached the longer term moving average. When I

asked him about his exits, though, he totally flabbergasted me. He said, "I've done this so much that I can look at a chart and pretty much tell how long the stock will keep moving up—whether it's going to be several months or just a few days." "How?" I asked. He said, "I don't know, I just can tell." That is the power of intuition.

So here was one of my better clients with whom I had worked to clear out enough psychological issues that he could plainly hear and follow his internal guidance. That guidance directed him toward this sort of trading. Then, with experience following his guidance, he developed intuition in two additional ways. First, he could just tell when to enter into a position. Second, and more impressive, he could just look at the chart and have a pretty good idea of how long it was going to be moving in his favor. That is superb intuition, which helped him produce a 5100% return in 14 years. After trading for that period of time with those kinds of returns, he listened to his internal guidance unquestioningly in early 2008 when it told him to stop trading. Although he was proficient at shorting, I suspect that this final guidance saved him a lot of money.

You, too, can learn how to develop that kind of intuition by reading this book. Amazingly, developing your intuition and understanding the benefits for your trading psychology are the very kind of ideas that most traders want to pass over. They want facts and computerized methods that "work." My experience of nearly 30 years as a trading coach, however, has clearly demonstrated that you cannot become a superb trader based purely upon mechanical trading methods. Intuition is an integral component of the success for the best traders in the world. Keep that in mind as you read *Trading from Your Gut*.

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PREFACE

Zen and the Smooth Stroke

"I learned to approach racing like a game of billiards. If you bash the ball too hard, you get nowhere. As you handle the cue properly, you drive with more finesse."

—Juan Manuel Fangio

I grew up with a pool table in my basement, so I learned to play at an early age. As a kid, I could beat most of my friends because they didn't have the chance for practice like I had. I could also usually beat my father, who had taught me the game, because he didn't play as much as I did. So, in my own small universe, I got to think of myself as a pretty good player.

I wasn't.

At some point long after I left the house, my father started playing in pool tournaments at the local billiards hall near where he worked. It didn't take long before he was good to the point that I almost never won a game when we played. I went from being able to beat him pretty consistently to being totally outclassed. It was clear that I didn't know as much about playing pool as I thought I did.

Several years later, after I left the software company that I had started, I found myself with a lot more free time; so, I decided that I would learn how to be a good pool player. I followed my father's path and showed up to play in the local weekly pool tournaments in Reno, Nevada, near where I lived at the time.

Reno is a serious pool town. The United States Pool Players Association (USPPA) even holds its annual amateur nine-ball tournament in Reno. The best players from all over the country come each year to play.

As a practical matter, the presence of all these great players meant that I lost most of my games. Decisively.

I was used to playing eight-ball games with the occasional straight-pool game thrown in. The tournaments were generally

nine-ball tournaments, so I had to learn a new game. In nine-ball, you have to hit the balls into the pockets in consecutive order. The object is to be the first one to get the nine-ball into the pocket. So you first hit the one-ball, then the two-ball, and so on, until you get to the nine-ball. The first player to sink the nine-ball wins.

When you first start to play pool, you think that the object is to get the ball into the pocket. So you spend a lot of time worrying about aiming the ball and hitting it into the pocket. After a certain amount of experience, you get to be pretty good at pocketing a ball if it is not too difficult a shot. At this point, you also come to realize that the trick is not sinking individual balls; the trick is making sure you don't leave yourself too many difficult shots. This is especially true in nine-ball, where you are permitted to hit only one ball at any particular point, and then the next ball, in order.

So the key to nine-ball is controlling where the cue ball goes after it hits the target ball. The real aim isn't hitting the ball into the pocket—that's a given. What you need to do is not just drop the numbered ball, but also control where the cue ball stops so you can set up for the next shot. To do this, you need to learn how the way you hit the ball affects the path of the cue ball and to develop control over your shot. Acquiring this skill takes a lot of practice. A good nine-ball player makes each shot seem effortless because the cue ball lines up after each shot to make the next shot easy.

In pool, the act of hitting the cue ball with the pool cue is called the "stroke." A smooth, accurate stroke is the foundation of good pool play. I learned this while getting absolutely crushed in hundreds of games with some very good players. If you have a smooth stroke, the cue goes straight and the ball goes where you aim it. If you don't, then the aim won't matter. If you have a smooth stroke,

you can predict where the cue ball will end up. If you don't, you can't.

For me, the key to having a smooth stroke was not over-thinking the shot. After hundreds of hours of practice, I generally knew what to do. If I spent too much time thinking prior to taking my shot, I found that I would often force the stroke and miss the shot slightly. Sure, the ball might even go in, but I'd leave myself with a poor following shot. If I played the shot with my head, I would end up miss-stroking the cue ball.

After a while, I found that I got better—not because my knowledge of what to do improved; not because my feel for the shots improved; but because I became more comfortable with just shooting without thinking. I learned to trust my gut instincts.

As I began to trust my intuitive game, I began to play more consistently. I stopped over-thinking shots, and my stroke was more consistent. I'd learned the smooth stroke.

Over the years, I have noticed that over-thinking can harm performance in other areas. In particular, I have seen many traders paralyzed by putting too much emphasis on the rational analytical decision process. Many traders don't perform at their full potential because they only use part of their mind—the analytical and linear conscious mind of the left-brain hemisphere. They use their intellect but not their intuition.

They do this because they have not learned to trust their gut instinct and their intuition.

If you want to trade at the level of a trading master, you need to develop both parts of your mind—your smarts and your intuition. I'm not the first one to suggest this idea. Many of the world's most famous traders have said this before me. They were correct.

Although there are many books about trading analysis and techniques for the analytical mind, there is a lack of books about developing trading intuition. That's why I decided to write this book.

In *Trading from Your Gut*, I show how to develop your intuition and confidence in the decisions of your gut instinct so that you can use your whole mind while trading.

CHAPTER 1

The Power of the Gut

"The intuitive mind is a sacred gift and the rational mind is a faithful servant. We have created a society that honors the servant and has forgotten the gift."

—Albert Einstein

George Soros, one of the greatest traders alive, trades from the gut. He has widely remarked on the correlation between his backaches and trading choices. In the autobiographical *Soros on Soros,* he wrote:

> I rely a great deal on animal instincts. When I was actively running the fund, I suffered from backache. I used the onset of acute pain as a signal that there was something wrong in my portfolio. The backache didn't tell me what was wrong—you know, lower back for short positions, left shoulder for currencies—but it did prompt me to look for something amiss when I might not have done so otherwise.

Some traders might scoff at the idea of making decisions based on "feelings" or intuition. They see the trader's role as one who remains calm and collected, rationally choosing the right course while those around them are tossed about by their emotions. They believe that Soros is either lying or fooling himself. They don't see how gut instinct can help. Yet many successful traders feel otherwise. Who is right? Is one approach better than the other?

If you are one of those traders who doesn't believe that gut instinct or intuition has any place in trading, I invite you to keep an open mind. I, too, once felt as you did. After all, I was trained to take a very systematic and logical approach to trading as a Turtle. I believed that it was important to keep your emotions in check. I didn't believe in trading from the gut.

Trading from your gut is a way of tapping into the extra power of the right hemisphere of the brain.

What I didn't realize at the time, however, is that there is a big difference between trading emotionally and trading from your gut. Trading emotionally means reacting to fear and hope, which can destroy your trading decisions. Trading from your gut is different. It is a way of tapping into the extra power of the right hemisphere of the brain, which can be a powerful, effective, and entirely rational addition to any trader's repertoire.

Trading comes naturally to some people, as it does to Soros or my trading mentor, Richard Dennis, for example. They seem to have a knack for it that comes from a well-developed sense of intuition. This gut intuition can be developed through training and the right kind of experience. In this book, I teach you how to incorporate expert-level gut instinct in your trading.

Before I go further, it is important to further define exactly what I mean by **intuition** and **gut instinct**.

Intuition

In mid-November 2007, when the Dow Jones Industrial Index was above 13,000 and the S&P 500 Index was above 1,450, I attended the Trader's Expo conference in Las Vegas, Nevada. The Trader's Expo is the largest trading conference in the country; people come from all over the western United States to attend the conference. I had been invited to speak at the conference in conjunction with the publication of my first trading book, *Way of the Turtle.*

While I was at the conference, I was asked to do an interview with MoneyShow.com, which had set up a video recording studio in

one of the conference rooms. The interviewer asked me what I thought of the markets over the previous several weeks. Normally, my standard response is that I don't try to predict the markets. I had grown weary of giving advice and had found that specific advice is not generally useful to others when not considered in context.

This time was different. I decided to go out on a limb and advise that viewers be very cautious in their stock investments. I told them that I thought there was a higher than normal chance that the markets would go down a significant amount, that we were coming off a long period of steady gains, and that there was a good chance we had seen the end. The timing was prescient. It turned out to be the beginning of the downturn that would see the market lose more than 50% of its value over the next 16 months.

You may think my instinct had told me that the market would soon decline. This is only partially true. I thought the market was risky at that moment, for some very specific reasons that had nothing to do with my instinct as a trader. Where my intuition came in was in breaking my longstanding rule not to talk about what I thought might or might not happen. I just had a feeling that this time was different, that I should voice my concerns.

If you asked me, I could probably come up with some reasons I felt obliged to share my thoughts on the direction of the market, but these reasons would be somewhat contrived. The truth is, I didn't really know why I spoke up; I had an intuition, a gut feeling, but one without a logical basis that I could readily articulate. In fact, the rational side of my brain was arguing for me to keep quiet because I knew that predicting market movement was a fool's game. In

retrospect, I hope that sounding this early warning benefited the traders who saw the video.

Using Gut Instinct: Left Brain Versus Right Brain

Relatively recent advances in psychology and neuroscience show that human intuition can indeed serve as the basis for powerful rapid decision making. Our brains can make decisions using thousands of individual inputs almost instantaneously. This type of rapid parallel processing occurs in our right-brain hemisphere. Because of the speed of the right brain, it can be a powerful tool in the hands of an experienced trader. Unfortunately, too much reliance on an untrained gut can prove disastrous for the inexperienced trader. This makes proper training very important.

Analysis, linear thinking, ordering, and the need to find structure dominate left-brain thinking. We try to make sense of the world with our left brains and bring order to it. We categorize, theorize, rank, and file with our left brains. When you think out loud, you are using your left brain. Put another way, when you think *consciously*, you are using your left brain.

The right brain, in contrast, is concerned with the whole picture and the spatial relationships between each of its parts. The right brain is quick and intuits instead of reasons. If you've ever felt uncomfortable or unsafe but couldn't pin down the reason, this was your right brain's sense of intuition generating that feeling. The right brain excels at reading patterns and interpreting their meaning in the context of a larger picture, and it moves much more quickly than its counterpart.

Although the right brain can quickly come to a conclusion or recognize danger, it cannot generally explain the reasons why it has arrived at that conclusion.

This speed comes at a price. Although the right brain can quickly come to a conclusion or recognize danger, it cannot generally explain the reasons why it has arrived at that conclusion. This often puts it at odds with the left brain because that analytical part of the brain wants explanations for its decisions.

To better understand how the right brain works, it's worth looking at the processes embedded in neural networks.

The Artificial Brain: Neural Networks

In the 1970s and 1980s, researchers in computer science attempted to re-create the brain's function using simulated neurons connected through computer software. They created the first artificial neural networks. As research in neural networks continued, this technology proved to be excellent at recognizing patterns. However, the downside of neural networks was the same as that of the right brain and the speed at which it arrives at conclusions. Neural networks can rapidly reach conclusions, but it is impossible to examine a neural network to understand the assumptions it is drawing from.

The right brain works a lot like a neural network. It draws upon experience to reach suppositions, but we generally don't know the reasons for those conclusions, except as a feeling. So if the left brain

wants to explain and the right brain cannot offer explanations, which side wins in a battle of decision making?

The answer depends on personality.

Thinking Versus Feeling: Can't We All Just Get Along?

Psychiatrist and pioneering psychologist Carl Jung developed a theory that measured one's personality in three different areas. In each area, individuals had a personality that fell somewhere on a continuum between one extreme and the other. One of these is a continuum between thinking and feeling; scores on a test of this personality aspect measures the extent to which the right brain or the left brain dominates decisions.

Isabel Briggs-Myers and her mother, Katharine Cook Briggs, subsequently developed Jung's work. Their work has been popularized as Myers-Briggs personality types. The Thinking and Feeling axis (generally abbreviated as T or F) of the Myers-Briggs test is often equated with rational decision making and emotional decision making. Sometimes those who make decisions using their left brains (the T's) look at those who make decisions with their right brains (the F's) and think that the F's are being unreasonable when they cannot explain exactly why they make particular decisions.

Most schools are geared toward developing and training the left brain. Math, science, reading, writing, and rote memorization are all left-brain activities. This emphasis leaves some would-be traders with a relatively overdeveloped left brain and underdeveloped right brain.

A balance between left-brain analysis and right-brain intuition is critical for optimum trading.

A balance between left-brain analysis and right-brain intuition is critical for optimum trading, so training must overcome any disparity a trader has in his cerebral development. Every trader has a dominant hemisphere, but recognizing the nondominant hemisphere is also important, especially if this is the right brain.

The Two Trading Camps

Consider another way in which the fight between the left and right hemispheres affects trading, in the ideological battle between discretionary (gut) and system (left-brain) approaches. The trading world is divided into two fairly distinct camps. The largest camp consists of traders who consider trading an art, those who are called **discretionary traders**. A smaller group consists of traders who use a specific set of rules to make their trading decisions. These traders are known as **system traders**.

Often when traders first meet each other, they ask if the other trader is a discretionary or system trader. For most successful traders, the answer is rarely black and white, because trading styles generally fall on a continuum between the purely intuitive discretionary trader and the purely rule-oriented system trader. Individuals who think of themselves as discretionary traders range from shoot-from-the-hip traders who buy and sell when it *feels* right, to more methodical traders who use combinations of chart patterns and mathematical indicators to trade only when a set of conditions

have been met. Investors who think of themselves as system traders range from traders who use such a specific set of rules that they can be programmed into a computer, to those who use a loose set of rules in combination with their own ability to recognize certain patterns and market conditions.

The best discretionary traders tend to be right-brain dominant, using their intuition to decide when to make trades. This tendency is especially prominent among discretionary day traders who look to profit from small intraday price movements. For these traders, the speed of their decision making is often a critical factor if they are to be successful. They might describe their approach as having a "knack" for the market or a "feel" for the direction of the market.

Left-brain traders know exactly why they put on certain trades. They generally have a very specific set of criteria that must be met before they initiate a trade. In contrast, purist right-brained traders, who use their intuition almost exclusively, often don't understand exactly why they make certain trades; they just know when a trade feels right. This willingness to relinquish decision making to intuition or gut characterizes the hard-core right-brain trader.

System traders are most often left-brain dominant. They use a rational, systematic process to decide when to make trades. They often analyze their approach using computers to perform "what-if" analyses using historical data to determine the hypothetical results their trading methods might have earned in the past, a process known as **backtesting**. Left-brain traders don't trade on their gut or intuition; they trade using rules and strategies. These traders often think in terms of signals and triggers, as specific events that determine when to initiate a particular trade. Systems traders will have identified these specific criteria earlier, when they performed their backtesting and historical analyses.

Whole-Brain Trading

After reading my first trading book, *Way of the Turtle,* which lays out a very rational approach to trading, some readers might think that I believe left-brain trading is better or more valid than intuitive right-brain trading. I don't. Even though I got my trading education as a Turtle in a tradition that stressed a systematic approach to trading, I see plenty of value in the right brain's ability to quickly process lots of information to arrive at an intuitive conclusion. In short, both approaches have merit.

Whole-brain trading involves both hemispheres and is a balancing act between the brain's two primary types of cognitive function: logical reasoning, and intuitive feelings and impressions. The blend of right brain and left brain depends on the type of trading you are involved in. For extremely short-term trades, relying on the right brain is often the only practical approach. Traders simply do not have enough time to perform complicated analysis. Traders who are scalpers must trade mostly using their right brains. For longer-term trading, traders have plenty of time for analysis. Getting historical data for performing this analysis also is relatively easy. Therefore, longer-term trading is very suitable for the left-brain trader. **Swing trading**, in which trades are kept for a few days or a few weeks, is best addressed with whole-brain trading. Generally sufficient time exists for performing an analysis, but the data and tools available to the typical trader do not generally permit a completely systematic approach such as one might use for long-term trading. For this reason, whole-brain trading is virtually required for effective swing trading.

In this book, I show discretionary traders how to strengthen their intuition and gut instinct and how to incorporate analytical

tools that systems traders traditionally use. I also show systems traders how to use many of the tools and techniques that discretionary traders use, to develop more robust trading methods. My approach to trading, and the philosophy that I share with you in this book, is what I refer to as **whole-brain** or **whole-mind trading**.

Mastering the Art of the Trade

To become a master trader, to be able to intuitively make good decisions, you must first gain enough of the right kinds of experience. This is why doctors and nurses go through extensive training and supervision when they are new to the profession. It is why firefighters train in fire simulations, and why airline pilots train in flight simulators. Through this constant exposure and consistent practice, experts build up a library of experiences that they can draw upon when making decisions.

To become a master trader, to be able to intuitively make good decisions, you must first gain enough of the right kinds of experience.

The same holds true for the trader—the most effective training is trading itself. In this way, the experiences you encounter while trading train your intuition so that, in time, you can become an expert. Learning as a trader can be difficult, however, because of the price of mistakes. In trading, mistakes cost money. Fortunately, traders can develop their intuition to a high level of expertise without having to put their money at risk. I discuss several strategies for doing this in upcoming chapters.

Before I lay out these strategies, it is important to understand the pitfalls and dangers of relying on gut feeling and intuition if you have not yet received proper training. In the hands of a novice, gut instinct can be dangerous to your account balance. In the next chapter, "The Purpose of Gut Intuition," I cover this important topic.

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