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
Bestselling author of *Trade Your Way to Financial Freedom* and *Super Trader*

Praise for *Trading from Your Gut*

"For all those who wonder if the powers of right brain thinking could apply to the trends-and-charts universe of stock and options trading, Curtis Faith has their answer. In *Trading from Your Gut*, Faith taps brain research, neurological models, and the wisdom of experience to provide a roadmap for decision making in a new era of volatility."

—**Daniel H. Pink**, author of *A Whole New Mind* and *Drive*

"I consider a book to be worth reading if it helps me develop a major paradigm shift. The section in this book about how to train your brain to help you become an intuitive trader blew me away and gave me 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."

—**Van K. Tharp**, bestselling author of *Trade Your Way to Financial Freedom* and *Super Trader*

"Emotions are not tools of cognition. How we feel about a stock has no bearing as to how it performs. But with the skill of both a trained psychoanalyst and market pro, Curtis Faith's *Trading from Your Gut* examines the human instinct behind our investment decisions. Because we are too often our own worst enemy in the markets, this is a unique and thoughtful guide to overcoming the biggest hurdle of financial success…ourselves."

—**Jonathan Hoenig**, Portfolio Manager, Capitalistpig Hedge Fund LLC and Fox News contributor

"Curtis Faith's *Trading from Your Gut* pulls off a difficult task—extracting pithy, simple trading strategies from the complex world of behavioral finance and psychology. The author of the hugely successful *Way of the Turtle*—an essential read for any committed trader—Faith takes the insights derived from psychology, marries them to cogent observations by master traders like George Soros, and then superimposes them onto a series of analysis-based theories to deliver a cogent trading plan.

As Faith observes, reading this book should enable you to combine 'your smarts and your intuition,' all achieved with a left field combination of wisdom derived from Formula One racing drivers, skydivers, Napoleon Bonaparte, Roman military theory, and Jessie Livermore. Next stop? Combining quantum theory, the wisdom of Ben Graham, the genius of proper investing, and tips on how to survive volatile markets?"

—**David Stevenson**, FT's "Adventurous Investor" columnist

"From the start, Curtis Faith makes clear the difference between allowing emotions into trading and trading from the gut—emotion has no place in trading, whereas he asserts that your gut feelings can make the whole difference between mundane trading and master trading. Through a process of discovery, with many entertaining stories and examples, Faith explains his findings and leads the reader into developing a whole-brain approach to trading, utilizing both analytical and instinctual powers. With the encouragement of this book, you will learn to listen to both your intuition and your intellect to become a more complete trader, giving yourself the edge for success."

—**Alan Northcott**, author of *The Complete Guide to Investing In Short Term Trading*

Trading from Your Gut

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Trading from Your Gut

How to Use Right Brain Instinct & Left Brain Smarts to Become a Master Trader

Curtis Faith

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For my two grandmothers,
Edna and Esther

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Acknowledgments

This is my third book. You would think that after completing the first two, I would have a pretty good idea how much work is involved in putting a book together.

Except I keep forgetting. It's a lot of work.

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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.

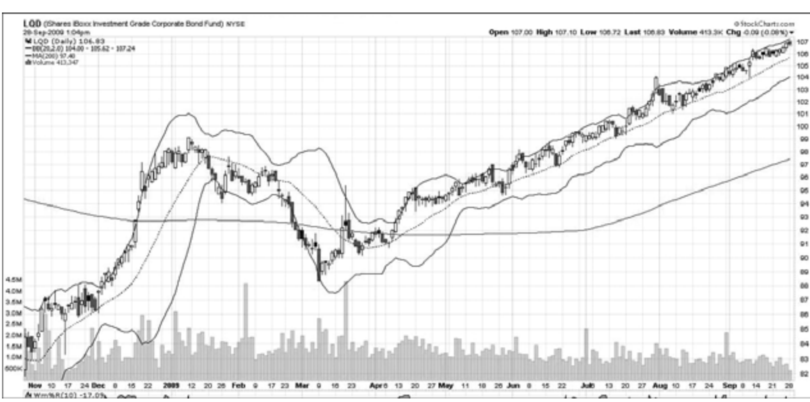
One point that Curtis makes and repeats again and again in this book is that you must train your instinct to get the best results. Because I agree with that, I kept on reading—and I'm glad I did. Chapters 6 through 8 blew me away. In this section, Curtis shows you how to train your brain to help you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

Van K. Tharp, Ph.D.
NLP Modeler and Trading Coach
www.VanTharp.com

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.