Jack Schwager is a founding partner of FundSeeder, an online platform for connecting seed investors with undiscovered trading talent. Previously he was a partner in the Fortune Group, a London-based hedge fund advisory firm that specialized in creating customized hedge fund portfolios for institutional clients. His earlier experience includes 22 years as director of futures research for some of Wall Street's leading firms and 10 years as the co-principal of a commodity trading advisor. Mr. Schwager has written extensively on the futures industry and great traders in all financial markets. He is author of a best-selling series of interviews with great hedge fund managers of the past two decades: Market Wizards, The New Market Wizards, Stock Market Wizards, Hedge Fund Market Wizards, and most recently, The Little Book of Market Wizards: Lessons from the Greatest Traders.

I&W: What makes for an outstanding trader (your so-called market wizard)?

Schwager: It is not one thing but rather many, many factors that contribute to making a market wizard. Any way that I answer this question will be sorely deficient. In a sense, the Market Wizard books are an answer to this question. But I can at least summarize a few of the essential traits.

Market wizards are not emotionally invested in their trades. They have a method and follow their method. They have no loyalty to their positions and are able to change their minds quickly when the facts so dictate. Changing their minds means not merely getting out of a trade when the facts change but even reversing their positions when they decide they are wrong. It was a common occurrence when I interviewed traders over multiple sessions that they would be strongly bullish on a market on the first interview and strongly bearish on the same market in the second interview or vice versa. Virtually all market wizards also understand that controlling losses is more important than winning. Note that I didn’t say, “avoiding losses,” but rather, “controlling losses.” Successful traders understand that they can’t win without taking losses, but the key is not letting any single loss do much damage. Another trait of the market wizards is that they don’t give up. Many of the great traders I interviewed made financially disastrous mistakes early in their careers, some of them even wiping out more than once. But regardless of these difficulties, they were persistent because of a strong sense of self-confidence that they would eventually succeed if they just kept at it.

I&W: Are they more prevalent in particular investment disciplines?

Schwager: No, I really don’t think so. Some of the traders I interviewed used only technical analysis, while others used only fundamental analysis—often with disdain for the opposite approach. There are also many traders who combined the two. Some traders used complex quantitative methodologies, while others were completely non-mathematical. The traders also ranged across entirely different markets including equities, foreign exchange (FX), futures, and options. There was also no commonality in time horizon, with approaches running the gamut from day-trading to multi-year positions. If there is anything I have become convinced about in doing these interviews, it is that there is no single right approach or best market, and even if there is at any moment, in time, it will change.

My advice to traders is always: Don’t worry about finding the right approach, but rather finding the right approach for you.

I&W: How can they be recognized?

Schwager: Of course, they can be recognized in hindsight by the track record. But, otherwise, it is very difficult to gauge who will be a market wizard. Even those traders who have initial great success don’t necessarily maintain it. One trait they do share is a strong confidence in their ability to be successful in the markets. Another is a passion for trading the markets as a game-like challenge—an endeavor they would probably be drawn to even if it didn’t offer the potential for great monetary rewards.

I&W: How do they successfully mitigate risk?

Schwager: There are, of course, many different approaches to risk control, but most share a focus on limiting the amount of damage that can be caused by a losing trade or multiple losing trades. One simple rule that was used by a number of the traders is to never risk more than 5 percent on any single trade. The “X” of course varied from trader to trader but was usually a small number—1 percent or less. A number of traders mentioned the necessity of deciding on an exit point before entry. Bruce Kovner, founder of Caxton Associates, stated this principle effectively and succinctly as the following: “Decide where you will get out
before you get in.” I think this line may be the single most important or valuable advice offered by any trader. The reason for deciding where to get out before you get in is that before you enter the trade, you have complete objectivity; once you are in a losing position, emotions will cloud the decision process. Some traders also seek to control risk by limiting the amount of loss they will allow in any given period (e.g., year, month). One point that should be made is that effective risk control does not have to be complex; it just has to be applied with discipline.

I&WM: What are the major changes to recent trading practices and how have those changes affected market wizards and their strategies? Should investors be more concerned?

Schwager: The biggest change that has occurred since my first Market Wizard book, which came out in 1989, is the exponential growth in computing power and the resulting huge increase in the use of computers for trading. Without question, many trading approaches are being used today that would have been impossible 25 or more years ago. I don’t know that this change should be a source of particular concern to traders. For one thing, the power of computing also aids individual traders and makes it possible for them to employ approaches that would have been impossible before. For another, professional traders always had a built-in advantage over the individual trader; it is only the nature of the advantage that has changed. As far as high-frequency traders go, yes they draw money out of the markets, but there were always middlemen drawing profits out of the execution process. Anyone remember the enormous bid/ask spreads in stocks decades ago?

I&WM: What is the difference between a trader and a speculator, and how do you tell the difference? Is speculator a negative term?

Schwager: This is a semantic question and really depends on the implications the user attaches to the word “speculator.” If the word is being used to refer to someone who takes a position in a market because they have a good reason to believe that a move in one direction is more likely, then there is no difference between a speculator and a trader. If, however, the intention of the term is to imply a person who takes gambling-type risks, then they are completely different concepts. Successful traders are not gamblers, and gamblers invariably are doomed to failure in the markets. The key difference is that traders take positions when the odds are in their favor, whereas gamblers will take risk even when the odds are against them.

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I&WM: What do you consider to be the most critical investment fallacies? What advice would you offer to the IMCA audience?

Schwager: Perhaps the most pernicious investor mistake is to select investments based on those with the best recent performance (e.g., past one–five years). Investors will tend to enter the stock market after it has done very well in recent years. Similarly, people tend to invest in sectors or strategies that have significantly outperformed in recent years. This type of approach works very poorly. Just because an investment has done very well in recent years does not make it more likely that it will do well in coming years. In fact, often, the best sectors or asset classes in recent years tend to underperform in the following years. The basic reason is that once a market has outperformed sufficiently to attract strong investor interest, prices are likely to be overdone and fundamental changes may be in place to alter the prior bullish situation. Research that I have done, which was documented in my book Market Sense and Nonsense, suggests that, on balance, investing in the recent-past worst performers may be a better strategy than investing in the past best performers.

The purpose of Fund Seeder for traders would not be to seed an initial account but rather to gather investor assets (or additional investor assets) to manage. The time necessary before raising investor assets would be dependent on the individual investors and their requirements. Fund Seeder will have the in-house capacity to audit past track records at cost for those traders who wish to be able to display a longer verified track record. It is anticipated that most investments will be via managed accounts. For some traders, investor interest could lead to the formation of a fund the trader manages, but not directly by Fund Seeder because we are a technology company, not an investment company.

I&WM: How will you identify seed investors to match with undiscovered traders?

Schwager: You are referring to our website fundSeeder.com. One beauty of the site is that we don’t have to match seeding investors with emerging traders; they match themselves. Fund Seeder provides the forum with which traders and investors can connect. Traders sign up to have their results verified real-time through brokerage data feeds. Investors use the site’s platform to search for traders meeting their criteria. If an investor is interested in a particular trader, they can request the contact information, which we then provide.

I&WM: What are the general target funding requirements for a trader to execute his/her strategy? How long do you envision that they would run an “incubator” strategy before going public?

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A second critical investor fallacy is the confusion between risk and volatility, with the

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two being used almost interchangeably. We have reached a point where many investors, including professionals, use volatility as a proxy for risk. Although there are situations where volatility can serve as an indicator of the risk level, there are also many situations where this approach will lead to disastrous investment decisions. Most importantly, low volatility does not necessarily imply low risk. In fact, many low-volatility investments may be subject to enormous risk. The key point to understand is that there are many investments where risk shows up only sporadically when there is a detrimental event to the strategy. In the interim, the investment can generate steady, low-volatility returns. If the track record does not include any adverse events, the investment may appear to be very low risk, even though it may be subject to large losses if there is a negative event. For example, credit-based strategies can generate steady returns at low volatility for stretches of time but then be subject to huge losses if there is a liquidity crisis. Looking at the track record may offer no clue as to the inherent risk. As another example, strategies that sell out-of-the-money options will realize positive returns in the vast majority of months, but if there is an abrupt, large price break, these strategies can begin to lose money exponentially, as the exposure of the underlying positions increases as the market moves adversely to the positions.

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