Interview With a Trading Legend

*Peter Brandt, author of Diary of a Professional CommodityTrader, may be the greatest trader you've never heard of. We consider him a legend thanks to his stunning performance – **a thirty-year track record (audited) of 41.6% compound returns**.*

Just as impressive is the manner in which those returns were achieved. Over a multi-decade span, Peter's best year topped 600 percent… and yet his worst losing year (of which there were only four) was a single-digit decline of less than 6 percent! (How did he do it? That's one of the questions he'll answer.)

Peter's history is intertwined with the futures markets. He was one of the early hedgers for major commercial operations… an early adopter of Schabacker, Edwards and Magee in commodity trading… and even a trader for the legendary Commodities Corp., the birthplace of "Market Wizards" like Marcus, Kovner, Seykota and Jones.

In addition to the above, Peter is relaxed, down to earth, and an all-around great guy. Mike McD and I had the privilege of hanging out with him over a snowy weekend in Reno/Tahoe, and conducting the following interview.

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Part I: Introduction to Peter Brandt

In part I of this multi-part Mercenary Vault series, you'll find out all about how Peter got started in trading… how he handled his early "going bust" experiences… and the first big move (in the Swiss Franc) that really put him in business as a trader.

JACK SPARROW: *So, just to get things started, this is the Mercenary Trader interview with Peter Brandt, author of Diary of a Professional Commodity Trader. Why don't you start off by telling us a little bit about how you got interested in trading, and just how your journey in markets began.*

PETER BRANDT: Sure. I lived in Chicago… we moved to Chicago in 1972, right out of college. I went to work for a big advertising agency, living in a suburb just north of Chicago – Evanston, Illinois.

I had a young son who played hockey. And so it ended up that a father of another hockey player living just down the street from us was a soybean trader. And I really liked the man, he was a good guy. He'd invite me down to lunch, "Come on down to the Board of Trade and have lunch with me."

And so I would visit him, and then there was a Board of Trade members' dining room, which overlooked the trading floor. At the time it overlooked the Wheat pit… and he took me on the floor and I was captivated. These guys are yelling and screaming, shouting matches, pushing people… I thought "This is crazy."

But I was really entrepreneurial. I had earned my own way in life since I was quite young. I had parents who split up, and I was raised by my mom and we were a welfare family… so from the time I was young I was figuring out ways to make money. And the Chicago Board of Trade was captivating. These floor trader guys had freedom, they didn't report to anybody, they made their own way in life… they knew how they did at the end of every day… that to me was ideal, and it was a question of just "How do you break into that business?"

JACK SPARROW: So how did you actually break into the business?

PETER BRANDT: I just went literally door to door at the Board of Trade asking people "How do I get into this business?" And it ended up that Continental Grain, owned by a European family, which at the time was the second largest grain exporter in the world next to Cargill, were starting to look to do commercial business with individual farmers and grain users: food companies, smaller exporters, and so on.

And so they wanted to do more on the floor than just their own trading, and they were looking for "customer's men." You know, people who could learn the grain business and bring in other customers who could also do the grain business. They had all the memberships so they figured they might as well take the commission, and work the commission side of the business.

So I went to work for Conti, the futures market division of Continental Grain, and at the time I think I was making $28,000 a year in advertising. And so I went to the president of the advertising agency and said "Look, I'm doing this. I'm going down to the Board of Trade, and I'm going to try it out. If I blow it – if I screw up – can I come back in a year and get my job back at a fifty percent raise." And he said yes!

And so I had the "license to fly." I went to the Board of Trade, started learning the business, learned the grain business primarily… a little bit of livestock… and my big client in advertising was the Campbell Soup Company (although I also worked on the McDonald's account).

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I knew the president of Campbell's really well. He was kind of a rebel guy, had been president of Campbell's Canada and now was heading Campbell's USA, John Morris, and so I went to him and said: "Why don't you send a purchasing guy out to Chicago and work with me to determine whether Campbell's ought to be using futures?" Which they did. A guy came out for a few months.

And the premise was we would go back to the top management team and tell them the truth – either there's nothing here for you (in respect to futures) or there is something here. And it was just a layup. Campbell's use of futures was just a no-brainer.

JACK SPARROW: What made it a layup? Why was it such a no-brainer?

PETER BRANDT: Oh, because they used cocoa, they used soybean oil, they used sugar… although sugar is funny, the sugar #11 contract is all the sugar nobody has bought under a long-term agreement. It's the non-wanted sugar in the world, and that's why it's so crazy. Most sugar in the world trades under long-term agreements. It's called contract sugar. And then you have the #12 Sugar contract in the US which is domestically protected sugar. The #11 sugar is basically the sugar that's not spoken for. That's why it vacillates so much, because it only represents about 10 percent of the world's sugar production. But that portion of the world's production can disappear quickly. Or it can glut quickly.

So Campbell Soup used sugar, they used beef, they grew 150 million chickens a year from scratch… they contracted with corn growers and bought soybean meal for their grow-outs… and we ended up really working out some fascinating hedges for them. For example we worked out hedges on the feed ratio, the cost to produce cattle, chicken or pork per pound. We'd look at the price of the live pig or cattle on the hoof compared to the different cuts they were using, and so they might buy forward on some of their needs, or they might sell short against their inventory depending on what the spreads were. Or they might sell their chicken production to the Board as iced broilers if it made economic sense to go out in the free market and buy their chickens. So we really got creative in how Campbell Soup used the futures. And they became a big commission client of Continental Grain.

JACK SPARROW: When did the focus shift to your own personal trading?

PETER BRANDT: I knew then that I wanted to start trading for myself. So I started dabbling a little bit, accumulating a little bit of money, starting in '78, doing some trades… and I didn't really know what I was doing.

One of the first trades I did came from my friend in Evanston who was the bean trader. I was just learning the business, and he had told me he was really bullish on soybeans: "Peter, I'm REALLY bullish on these beans."

And so I watched them for a few days – I think they were around $5.50 or so – and I'd saved up a few thousand dollars to speculate. And they crept up like ten cents, and so I bought a contract, and they went up like five more cents – and then they went down twenty cents.

And so I got out with my loss, and eventually saw John again and said: "John, so what about those beans?" And he said "Yeah, was that a magnificent move or what?"

JACK SPARROW (laughing): Oh no…

PETER BRANDT: Yeah, and I said "What are you talking about?" And so it ends up that John is a scalper. He never takes a position home at night. He trades the beans for half a cent to a penny, and he had such a conviction on beans that he had a position he was willing to carry for three or four days. Well I find this out after the fact. He takes ten cents out of the bean market, which for him is a gigantic move, and I wasn't even thinking that way!

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And that was a good lesson. Traders at the Board of Trade would constantly say they were bullish or bearish, and it was a good lesson that the words “bullish” or “bearish” did not mean anything. I would have to ask, “What’s your timeframe? How long do you hold trades? How much money are you looking for in a trade? Where are you wrong – what will tell you that you’re wrong? Why are you bullish or bearish, what do you know?”

And so I learned really early on that bullish or bearish didn’t mean squat.

JACK SPARROW: So was that your “going bust” experience? Or did you have a going bust experience early on, as so many professional traders do?

PETER BRANDT: Sort of, but I went bust in little bits. You know, break open the cookie jar, take two or three thousand bucks out, and trade until I was forced to just trade oats!

JACK SPARROW (laughing): So you kept getting bumped down the ladder on contract margin.

PETER BRANDT: I did. But then I’d build up a little bit, you know, put some money away from Campbell Soup… I also had some money from other customers that came in. One of the things that helped was that I had the nerve to approach Homestake Mining in South Dakota. I knew nothing about gold, and they didn’t do any hedging. But I went and pitched them and they ended up hedging some gold with me. And so they became a gold client. And again, I know nothing about gold. But I was the guy that went and pitched their business.

JACK SPARROW: This was before hedging was a common practice.

PETER BRANDT: Right, nobody hedged. Except for grain merchandizers, companies didn’t hedge. The tax implications of corporate hedging hadn’t been clarified… most commodity-connected companies just didn’t do any hedging.

But I picked up a few valuable clients. I ended up getting another customer that just traded tons of copper – a giant copper user. They made paint for the Navy. You know the gray paint? The paint used on Navy ships had a very large copper content. And that’s what kept the metal from rusting. All that paint that they put on ships contains something like 15 percent copper. So the company was a huge copper user.

And so I had those three clients and that was mainly it. And I would save a couple thousand and I would trade it. I didn’t know what I was doing. I was listening to different people with different ideas, and one guy even had this plastic thing he used to identify cycles. I tried many approaches such as cycles… and seasonals… point and figure charts… fundamentals… I didn’t know what I was doing, and I kept losing money.

To answer your original question, yes, I went broke, but I went broke many times in little amounts. I would save up five grand, save up ten grand, blow it. And I just constantly was losing, not knowing what to do next.

MIKE McDERMOTT: A lot of people would have given up at that point. What made you convinced that you could learn this?

PETER BRANDT: I was in the business and I knew I was going to be there. The commission side of the business was covering my expenses, and I was not risking huge amounts in the trading account. A year had passed and I had stayed… I had come to the point where I was making a lot more than I was making in advertising… so I was making a fairly good living. This was 1978, and I was making sixty or sixty-five thousand dollars a year, which was a lot of money back then.

JACK SPARROW: So you could basically fund your trading experiments.

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PETER BRANDT: I could fund the losses, but I still had expenses. I had bought a home, I had a family to support, and I even bought a BMW — the worst car I've ever owned, I'll never own German again.

MIKE McDERMOTT (laughing): Ouch, don't say that.

JACK SPARROW: What led to the breakthrough?

PETER BRANDT: Well I met this guy who said, "I trade these patterns. I buy these chart books each week and I draw these lines and look for geometric patterns. You ought to go down to the Board of Trade bookstore and buy this book by Robert Edwards and John Magee. Buy the book and read it."

Which I did – the book had a yellow and blue cover. And so I started reading this book, and I felt like "Okay, I'm at home now. I understand this. I can do this." It just made sense to me. It was clear, it wasn't mechanical – because at the time people were starting to play with mechanical approaches –

JACK SPARROW: And again this was around 1978?

PETER BRANDT: Yeah, '78 or '79… and so I consumed this book, gathered some more money, and figured I really liked this approach, and I could trade the approach without going bust again. But I wanted to trade the approach with the proper amount of capital. So I accumulated a pretty good amount to start with compared to previous attempts when I would fund an account with only a few thousand dollars – and then lose the money. I decided I would put a better chunk of change together so that I could actually hold a position and not get knocked out, and I was going to try and trade it the right way.

So I can't remember the exact amount, $20,000 I think it was. And I started to make a little money. Lose a little, make a little… and I started to make enough that I felt comfortable. Then it was "I just have to make a decision to do this. I can't be a customer's guy and a trader."

And so I left Continental Grain and went off on my own. I still kept a relationship with Campbell Soup to cover expenses, but started trading. And it went well. I made money the first year, made a lot of money the second year… and so my account was growing, but I didn't feel like "I've arrived," that I had enough where I could say I'm REALLY a trader. I'm still kind of hanging on by my fingernails. But my account was growing.

And then something happened in the currency markets in 1982 that changed the game for me. Foreign currencies were trading at the International Monetary Market divison of the Chicago Mercantile Exchange. And the European currencies set up in a way that just sang a song for me based on the charts. And I felt so strongly, that "this is it…the time to bet the farm."

And it was Wednesday, the day before Thanksgiving – Thursday was Thanksgiving, Friday the markets were closed in the U.S., Saturday and Sunday the markets were closed. And on Wednesday the Swiss Franc broke out.

MIKE McDERMOTT: The day before Thanksgiving.

PETER BRANDT: Yes, the day before Thanksgiving. And I bought ten contracts, which for me was a lot. That was equal to $1,250,000 Swiss francs, which for me at the time was a huge position. I bought late in the day when the market was already up about 50 points – the market ended up closing something like 70 points higher.

And I called London on Thursday, and the currency traders there just didn't care what had happened on Wednesday in Chicago. It was "Who cares what the IMM did." The value of the Swiss Franc did creep higher in London on Thursday, but was still way below where the IMM had finished on Wednesday. I talked a banker into selling me ten contracts of deutschemarks on that Thanksgiving Thursday.

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So now I'm long ten Swiss, I'm long ten deutschemarks, it's Friday… London was still not a believer of Wednesday's strength at the IMM and the Swiss Franc opened lower in Chicago. But despite Europe's hesitation, the U.S. took the lead on Friday to strongly rally the European currencies. By the end of the trading day at the IMM on Friday I had a significant profit in both the D-Mark and the Swiss Franc. I had a feeling that on Monday London would again not be a believer of Friday's rally in the U.S. Yet, I slept well over the weekend. I just felt like "London's wrong. The U.S. is right."

By Monday morning the tone in Europe had changed to be in line with the strength in Chicago. The European currencies opened higher at the IMM and didn't look back. The Swiss Franc and D-Mark just went straight up for the next five weeks.

With that trade, all of a sudden I had a serious amount of money in an account. And from that point on I could seriously consider myself to be a trader.

JACK SPARROW: You reached that critical mass.

PETER BRANDT: I reached that critical mass. I was like the other guys I knew at the Board of Trade who really were traders. All of a sudden I had the capital to "be a trader." I could hold onto positions, I could build big positions, and I could trade enough to where I didn't have to triple my money every year to provide living expenses.

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Part II: Mental Milestones

In Part I of this Mercenary Vault series, we introduced you to Peter Brandt — a 30-year veteran trader with 41.6% annual compound returns.

Part I covered Peter's entry into the Chicago futures markets in the 1970s… his experiences as a "customer's man" and early commodity hedger… "going bust in little bits" and finding his feet as a chartist… and the currency trade that really put him in business as a trader.

In Part II we cover (among other things) mental milestones… teaching opportunities… win/loss ratios and drawdown realizations… position size and leverage considerations… and Peter's ideal trading conditions as a chartist.

JACK SPARROW: So around the time of your breakout trade in the currency markets, what steps were you taking to become a trader? What were some mental milestones on your journey?

PETER BRANDT: Trading based on charts made sense to me, but just saying this does not start to explain the amount of work that was ahead of me. I just started systematically figuring out the charts – by this I do not mean the simple recognition of patterns, but rather the practical challenges of trading in real time. It's fine to be a chartist, but what does it mean to be a chart trader. Analyzing charts and trading the charts are two entirely different challenges. Do I trade one-week patterns? Two-week patterns? Reversal patterns or continuation patterns? Where do I place protective stops? How do I enter a trade? Working through the process just took time. In fact, this process continues to this day.

You just keep working through the mechanics of how you conduct the process of trading. What's your game plan? How do you get in, how do you get out? Then obviously you go through periods when the market spanks you and you're wrong four or five times in a row. And you start questioning whether you need to change something.

So you go through that process enough that you begin to figure things out over time. Then, just about the time you think you have it figured out, your adopted approach gets challenged by the markets. But that challenging by the markets is good. Enough challenges force you to say "I don't care, it's just part of the process." The continual challenges brought forth by trading also forces a trader to refine, refine and refine his or her approach.

JACK SPARROW: Were there any particular realizations that stood out in the very early years?

PETER BRANDT: For me, one of the biggest things was realizing I was not going to be right 80% of the time, or even 50% of the time. I would be right about 35% of the time – but that was over an extended period of time. And this figure became real predictable throughout the 80s. If someone had told me, "This year, you're going to be right 35% of the time," I could have guessed within plus or minus 10 or 15 percent what my return was likely to be. If someone had told me, "This year you're going to be right 40% of the time," I had a pretty good feel of what that meant.

That figure of 35% was and still is true over an extended number of trades, where N as the number of trading events was a large figure. Percentages tend to work out over an extended number of Ns. But over a shorter-term number of Ns it can really change. I began realizing that over 10 or 20 or even 30 trading events, the win/loss ratio deviated considerably from the norm – with a win/loss ratio that could go as low as 10 or 15%.

At that time I went to the statistics department at Northwestern University, just down the street from our home in Evanston, sat down with a professor and said: "Figure out for me what the odds could be of being wiped out betting different amounts of my capital on every trade. If I'm right 35% of the time

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over a large number of Ns, what's the chance that I'm going to be wrong, just in terms of random distribution, 8 times in a row, 10 times in a row, 15 times out of 20, and so on."

JACK SPARROW: Trying to find the extreme statistical outlier for losses.

PETER BRANDT: Right. I knew the answer would resemble a bell curve, but I wanted to know what things looked like to the far right and left of the hump. And the professor created a model based on probablities involved in rolling a single dice. And he said, "A dice role of the numbers one or four are your winners, the other numbers are your losers. Now let's just go through a very long series of dice rolls and see what happens."

The professor ran a computer program and produced a distribution table and bell curves that gave me a considerable amount of insight into the random distribution of winners and losers given various win/loss ratios. I began to realize that risking 4 or 5 percent of capital in a program that was right on 35% over an extended number of trades, but with a high probability of being wrong 80% or 90% of the time over shorter numbers of trades, was a recipe for ruin.

And that's how I came to the conclusion that I should generally not risk any more than 1 percent of capital because I realized, based on the mathematical probabilities, that it was inevitable if I risked even 3 percent of my capital per trade each time, I could seriously harm my capital base to the point I would then have to change the way I traded the markets. And that's exactly what I didn't want to happen.

That starting point on risk led me through the whole process of learning leverage, and how leverage is built. I think back on a lot of the stuff I had to learn and it's often because I took a hit on a trade and realized "I hadn't thought about that," or "That was not a part of the equation I thought was right." And so I was continually forced to go back and rethink an aspect of the trading process all over again.

Of the new people who start trading today – so many have no clue of the learning curve. I mean this is a steep mountain. And you've got to be willing to really, really go through a lot of learning – and you learn by mistakes. You learn by getting sliced up by the markets. You don't come in, have a hot three months, and say, "Man, I've got it figured out." You learn when when you realize, "Oh, I've been wrong 8 trades in a row, and now I'm getting another signal, or, I've just lost 20 or 30 cents in a 10 cent trading range," and so on.

And I just went through these situations again and again, and these were the challenges of the game for me.

JACK SPARROW: So how long was that period between when you first discovered Edwards and Magee and realized, "This is the approach I like," to the Swiss Franc breakout trade that established you as a trader. How long was that interim?

PETER BRANDT: Maybe two-and-a-half years. But then even after that, I had a lot to learn. Any approach you take is complicated. So it was 1982, and there was the big move in the currencies that launched me – but then it was just a process of learning more about the markets, myself and my approach, making even more mistakes, feeling better about it, going through drawdowns.

You go through a big drawdown, and your first temptation is "I've got to change something." And actually I think the best response is not that something has to be changed, although that may also be the case, but something has to be learned.

JACK SPARROW: A teaching opportunity.

PETER BRANDT: Right. Trading is an ongoing education. But like all other forms of education, a tuition has to be paid. When you make money, that's great. When you start losing money, that's the tuition you pay to learn. And the market gets to determine the tuition, you don't get to determine it.

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Let me add something very important about trading and drawdowns. There is very little material printed or online for the beginning trader on the subject of drawdowns. This is very unfortunate, because drawdowns are a harsh reality of trading. As a result, beginning traders have false expectations of the trading environment. Drawdowns are a fact of trading, and how a trader deals with drawdowns will determine the end game. It is like the word “drawdown” is a subject that is off limits and seldom discussed. Given that every trader deals with drawdowns and asset volatility, it is sad these subjects are not discussed with more transparency.

JACK SPARROW: Speaking of drawdowns, how many significant ones have you had over the past thirty years?

PETER BRANDT: It’s funny you should ask. I was just studying my drawdown history the other day. I’ve had 15 drawdowns that exceeded 10 percent – peak to trough to new highs. Many more drawdowns in the 5 to 10 percent range. Some people measure drawdowns peak to trough and that’s fine. But what good is peak to trough if you never make a new peak? You’ve got to measure the whole round trip.

MIKE McDERMOTT: You don’t know that the whole drawdown is complete until you’ve got a new high.

PETER BRANDT: Exactly. You don’t. And that is why you’ve got to go through the full cycle. And at first you’re tempted and you probably do tweak things, even making major changes, and you find out after the fact that the biggest mistake you can make is changing your trading style based on your previous trade or series of trades. Attempting to optimize a trading approach based on a recent series of trades is just idiotic to do.

You’ve got to think not in terms of results of a trade, but principles. Not just did I make a mistake but, for example, “Do I need to be more conscious of trend.” If so how do I determine and measure trend. Do I determine it with a moving average or with some other means? A trader is just constantly playing with these things.

But then eventually you go through a drawdown and you don’t change a thing, trusting that losing streaks come and go. But what I did find early on is that you do have to change the size of the bets you put on the table. That is because I came to the conclusion early on, with the help from the Northwestern University statistics department, that I’d risk about 1 percent of my capital on a trade.

And in a drawdown you even start playing with that. For me I reduce my risk even further when I start to lose. If I get hit a few times, well, then it’s going to be three quarters of a percent, or half a percent, down to maybe a quarter of a percent on a trade. Then you start winning again and you build up the size of the bet.

MIKE McDERMOTT: So your position size is based on the amount of risk that you’re willing to take.

PETER BRANDT: My formula is really easy. I look at a chart – for example corn is a market I’m involved in right now. I’m a breakout trader, and I’ll tell you, over time I have had to learn over and over again to resist the temptation: “This thing is going to go up, I need to get in before it breaks out of this pattern.” I’ve lost so much money in trading ranges. So much money trying to jump ahead of a trend.

JACK SPARROW: Because you didn’t wait for it to fully confirm.

PETER BRANDT: Exactly, I didn’t wait for the breakout. So that has been a hard lesson for me to learn. Intellectually I realize that the correct approach for me is to just stick an order in for a breakout and have a computer-based alert system so that I can know when I get filled instead of having to watch the prices all the time.

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So I get in and I have a rule for where I set my stop. I want to set my stop based on the chart, not based on a dollar amount. I want the stop to make technical sense. So I know my entry, I know where my exit is if I am wrong, I can figure out the dollar risk per contract, so only then can I calculate out my leverage.

So in corn it may be that I'm risking 12 cents. Or maybe I can get away with risking 4 cents. I don't want to force that number. I want the market to tell me, based on how it breaks out, where my stop is going to be. And that goes into determining my leverage.

MIKE McDERMOTT: And by leverage you mean number of contracts—

PETER BRANDT: Yes, number of contracts. I refer to this as my "size." And for me, I always think in units and layers, layers per $100,000. One contract is a layer. Two contracts, two layers. Three contracts, three layers. Per $100,000 unit of capital. And depending on how bold I am, how I feel about the market, I might risk up to 1.5% on the trade. There are times where I have risked 3%. But it's rare that I do that.

I am amazed when I talk to novices who tell me they risk as much as 10% of their capital on a trade! Well I did that too. Back in the late seventies I did that, and I can tell you it doesn't work! Risking 10% of capital on a trade is a well traveled road to ruin.

MIKE McDERMOTT (laughing): You don't usually talk to them three years later.

PETER BRANDT: No! They're not around. They don't last very long.

JACK SPARROW: As a chartist, how would you describe your ideal trading conditions?

PETER BRANDT: For me it's "Who cares what the label is on the chart – what market it is." I've always thought my perfect world would be this: I would be blacked out from ever knowing anything… never watching TV… never having to drive through a cornfield in the summer… never knowing any news… and some assistant would bring in charts in the morning, and the price scales would be modified and the name of the commodity would never be on it. It would just be lines and graphs, and I would have to mark it up and say, "Buy here, sell there," and the person would have to execute in accordance with the leverage rules. And so they do the execution, and I never have to know about it. Additionally, I would only be able to look at the charts for ten minutes each day and would not be able to see what happened until the next ten minute period in preparation for the next trading session.

JACK SPARROW: So with your track record of 41.6% over 30 years, do you think you would have done even better if you had shown the discipline to trade that way?

PETER BRANDT: I think I would have. I can't believe how much money I think I've left on the table because I get influenced by the name of the commodity traded, the price level itself, the emotional pull of the news of the day or other factors beyond the charts themselves – and still do so to this day.

In a sense, my perfect trading environment is the antithesis of the environment the Mercenary Trader attempts to create. I would love trading solitude between me and the charts with no other influence. You guys seek to make sense of a tremendous amount of stimuli. I mean you guys have traded enough to understand what it is like when you read something, you hear something, and all of a sudden light bulbs go off.

In your approach to market speculation, it's not a new thing you discover, but somebody shining a flashlight on something from a brand new angle – and all of a sudden it's not a two dimensional item but a three dimensional item, or even a four dimensional item. And then you say to yourselves, "A-ha! I see what this thing is. Now I understand what is driving price change."

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I love reading MercenaryTrader.com, but not for your unique macro-economic analysis or specific trading maneuvers. Rather, you guys will hit upon some aspect of human factor or risk control, some other seemingly arcane subject, that really sets off the light bulb in my mind. As an example, you recently introduced the concept of "leakage." I had never thought about leakage in that way – that I'm leaking money, and I've always been leaking money, and how do I stop the leakage. Because I can stop it! I can identify it and I can stop it.

But I had not thought about that concept the way you introduced it. I had thought about it as just, "This is the process of trading and you take all of these decisions, and all of these maneuvers, and at the end of the year you've got to live with the bad and live with the good." But now you can break it down and say there is such a thing as leakage that exists. You can isolate it, and you can study it, and you can find ways to address it. That for me was just a gigantic revelation, this leakage concept. I loved it.

So I'm working on leakage, because I think it could be costing me between 1 and 1.5% of my assets a month. And that's 15% a year! That is a huge amount of money.

JACK SPARROW: And then compounded it's even more…

PETER BRANDT: Well as a professional trader you don't look at it like that, because you're taking money out of your account to live on. But in a way it does compound, what remains in the account.

MIKE McDERMOTT: But if you're managing capital –

PETER BRANDT: If you're managing capital, your leakage could be the difference between being an "all-star" and an "also ran." You could be doing 10% a year and not recognized, or 25% a year consistently and become a top tier manager. So leakage really becomes important.

MIKE McDERMOTT: So where would you most easily be able to cut the leakage? Or where could most people look at it?

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Part III: Staying in the Game

In Part II of this Mercenary Vault series, we talked with Peter about mental milestones, win-loss ratios, and ideal trading environments.

In Part III we further discuss the topic of "leakage"… the "path of least regret"… the key to having triple-digit up years while cutting off down years… and the vital importance of staying in the game.

MIKE McDERMOTT (continued from Part II): So where would you most easily be able to cut the leakage? Or where could most people look at it?

PETER BRANDT: I think it depends upon the trader and trading plan, because every case will be different. We know that every trading approach, whether it is systematic or discretionary, can be in or out of sync with the markets to varying degrees. It is also possible for a discretionary trader to be out of sync with the trading plan. If a discretionary trader thoroughly understands his or her trading plan, then it is possible to identify leakage. I define leakage as areas where a discretionary trader fudges on the plan. In my case, the grand total of all my "fudges" have resulted in a net loss over the years. That is how I would identify leakage in my case. I think it's different for everybody.

JACK SPARROW: Can you give a more specific example of what that leakage would look like for you?

PETER BRANDT: One example, a big one, would be trading decisions I might make during active market hours. A good rule for me is: "Do not trade intraday." From the time I submit my orders, that should represent the sum total of my decision making. I should not change the orders, I should not second guess them. You know the concept of MIT orders, "Market if touched." In my trading I've had CIC orders, "Cancel if close."

So I put in an order and it becomes a CIC order. As the market gets there, I start to wonder, "Do I really want to sell this rally?" And I go through that, and it is all about fighting these human emotions. I also know instinctively that worrying about the money, looking at my trading balance is the worst thing I can do. It is important for a trader to trade the markets, not his or her capital balance. I mean you have to have capital to trade, but a focus on account balance and not the markets is a trap. I know it is a trap for me at times.

Sometimes it comes down to the course of least regret. Asking, "Will I regret it more if I pull the order and it turns out to be a perfect retest, giving me a double unit to ride back to the target – or will I regret it more if I put the position on with a nice tight stop, and risk losing a little bit more, but not much, in the big scheme of things, 30 basis points to make 400 basis points." That should be the basis of my decision.

JACK SPARROW: Always referring to the present opportunity and the present moment in time.

PETER BRANDT: Yes, "always attempting to determine the action that will represent my least regret." And I've got to take that course of action. To do that as an individual you have to think forward, in terms of your human psyche, how you're going to react to different situations. What's going to be your human emotion, how are you going to live with different courses of decisions and market outcomes.

Richard Dennis used to call it "the upstream swim against human nature." You're battling your fear, your greed, your hope… all those human emotions are your challenge, especially as a discretionary trader. Not that systematic traders don't go through emotional turmoil too. They do – in some ways I think maybe they go through it more.

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So for a discretionary trader it comes down to one of two courses of action. In the first, a trader second guesses too many trading decisions, fearing the risk of a drawdown, and ends up with no real trading plan at all. In the second, a trader knows they will go through drawdowns, they live through drawdowns and keep following their rules, and it takes them through.

Earlier in my career when I was encountering a drawdown I would frequently override trades, and not take trading signals, and then I realized, "You know if I just hang with it and keep following my signals, the drawdown will resolve itself." It is important for an aspiring trader to stick with a plan throughout a drawdown and go through a full cycle.

JACK SPARROW: Let me ask about the signals in your trading approach. Have your signals or trading decisions changed much over the years?

PETER BRANDT: For me my signaling hasn't changed much, although I'm moving toward the point where I'm wanting longer term signals – almost to where I can throw my daily charts away and just deal with weekly charts. In my head I'm sometimes thinking, "If I'm going to trade another 15 years, maybe I ought to throw the daily charts away and trade just on weekly charts."

JACK SPARROW: And to clarify, you're still talking in the neighborhood of a dozen trades a month based on your history.

PETER BRANDT: Yes, though maybe if I would go to just weekly charts the number of signals would come down to 8 trades per month. And that would include patterns that are at first a fake out and require one additional attempt at re-entry.

My rule on big patterns is that they fool me once and that's fine… then I'll let them fool me a second time… and after that I don't care what a market does. I'm not going to try the third time. "It's fooled me twice, that's my rule, let somebody else have the money who has more guts to pile in than me but I'm not going to re-enter a pattern that has already fooled me twice."

So, anyway, I'm thinking longer term chart patterns, move away from shorter term chart patterns. Although when you get a good strong trend, sometimes those two week flags can really be profitable. I mean they can really, really add money to your account when you see them and they work. And I would be giving up these shorter-term pyramid signals if I go exclusively to weekly charts. But that's fine – I know that the more detached I become from the markets, the more I remove myself in emotional proximity from markets on a day to day basis, the more I'm going to add to the bottom line at the end.

JACK SPARROW: Are you pretty confident you can do even better than 41% over the next 10 or 15 years?

PETER BRANDT: I think it depends. Proprietary money, I don't think that would be a problem if I am extremely disciplined. But naturally I'm going to be more conservative if I'm trading customer money. With the money of others I would not take as much leverage.

JACK SPARROW: Hypothetically, let's just phrase the question in terms of your own funds.

PETER BRANDT: If it's proprietary money, then I don't see that there would be any problem. Because when I consider my 41 percent, that includes 4 or 5 years when I was pretty much shut down and hardly trading. And those years are added into the performance calculation. During these years the performance was something like up 2 percent, up 3 percent, down 1 percent – I think it was 4 years in the 1990s where I really didn't do much.

JACK SPARROW: So what does the distribution look like? Does that mean you had years where you were up 150 percent, 200 percent, more?

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PETER BRANDT: Well I had 600 percent at the top side – a 600 percent year in 1987.

JACK SPARROW: And what contributed to that?

PETER BRANDT: I really clocked the S&Ps on the long side, early in the year. After the 1987 crash I was really out of sync with the stock market for something like two years. I don't think I made money in the stock market for a couple years after that. The crash really faked me out.

MIKE McDERMOTT (laughing): Obviously it didn't hurt you too bad.

PETER BRANDT: But then I also had a lot of 50 percent years… and I also have had 4 losing years…

JACK SPARROW: And your worst losing year was only minus –

PETER BRANDT: Minus 5.8 percent I think it was.

JACK SPARROW: Let's talk about that for a minute. Because for anybody reading this interview, a trading methodology where your best year can be plus 600 percent, and your worst trading year can be less than minus 6 percent – that's beautiful. I mean it's incredible. How would you explain to readers your ability to have such incredible upside while still, your worst year would be something most money managers would be ecstatic to have as their worst year.

PETER BRANDT: I think it's really an easy explanation. Jack Sparrow, I think it's actually a layup explanation. Minimizing losses during the bad years happens when you attend to taking care of your risk. And then you allow good things to happen. All kinds of good things can happen if you control your game.

JACK SPARROW: You cut off the left side of your distribution.

PETER BRANDT: You cut off the left side of the distribution, you try to eliminate it. And then all kinds of interesting things can happen. And you just do not let the game get away from you.

How many sporting events do you watch where you're in the third quarter of the game, or the fourth quarter, and the announcer says, "Such and such a team has just taken it to these other guys, but the other guys are still in the game." And how many of those games just turned in the last five minutes?

JACK SPARROW: Right.

PETER BRANDT: Because the dominating team outplayed the other team for most of the game, but they couldn't put them away. They couldn't take them out. The team that was getting beat – a touchdown down, a field goal down – they never got out of the game.

I think in trading, the concept of not getting too far behind in the score is so significant. It's a matter of risk control. Aggressive risk control protocols. If you attend to your losses, pay attention to your losses, that's it. For example, I have a trading rule that I won't take a loser home on a Friday. I don't care how I feel about the market, if on a Friday it's a losing trade, I'm gone. And I may get back in next week or I may not.

I used to have a rule that I don't hold as tightly to now, but I sometimes wonder if I should go back to – and that's not taking a losing trade home at all. Or not taking home a trade that's losing more than let's say, in you guys' terms, 30 or 35 basis points.

JACK SPARROW: It's basically got to work during the first 48 hours or you're done with it.

PETER BRANDT: Taking a trade off at a target is an easy no-brainer. Although if the market keeps running you question yourself, but basically for me it's pretty easy. I take the profit, I close the book,

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and I try to make it a habit not to look at that market again for another week or so. It's also easy to take a trade off at the loss point, where you set the risk.

For me the hardest part is what to do with a trade that has a profit and is still open. And I think most of the experimentation and tweaking and pondering and second guessing I do takes place with a trade that's somewhere between where I put it in and where I think it can go.

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Part IV: Maintaining the Center

In Part III of this Series, we learned about the “path of least regret”… the value of long-term chart patterns… the key to triple-digit up years (and single-digit down years)… and the vital importance of staying in the game.

In Part IV we hear more about protecting trade profits… staying “centered”… the characteristics of a big trade… the truth about a trader’s biggest opponent in markets… and the importance of removing the “emotional velcro” from money and trading.

JACK SPARROW: Do you ever use trailing stops or anything of that nature?

PETER BRANDT: I just categorically do not like trailing stops. I think what ends up happening with trailing stops, if trading from the long side for example, is that you end up selling where you should have been buying. And that doesn’t make sense to me.

JACK SPARROW: What about the concept of moving your stop closer based on logical chart points?

PETER BRANDT: Yes, I will do that. I’m not going to give all of the profits in a trade back. I refer to trades when all of the profits are given back as “popcorn trades” in my recent book – you watch the popcorn kernel go up to the top of the kettle and then it goes right back down. I don’t want to get caught in popcorn trades. It just doesn’t make sense to increase risk like that.

So I’ve got some methods that I’ve built into my trading over time for taking trades off, and I use these methods. I keep an excel spread sheet that constantly shows me how the three or four trade management approaches I could use would have done on each trade. One of these approaches I monitor is the possibility of riding the trade all the way back to the starting gate – a popcorn trade. No matter which trade management method I end up using, I have a tracking of how all the optional approaches are doing. Having this information keep me centered.

JACK SPARROW: And you also stay centered by communicating with other traders.

PETER BRANDT: I’ve corresponded with a group of traders since 1980. I started with a one-page typed out sheet with graphs, and every Friday I would do it. The guys at Continental would want a copy, so I’d make ten and put them on the front desk. Then I’d end up making thirty copies as other traders from the Board of Trade came around, and of course it eventually went to email. I have continued to do this over the years. I weekly send out a PDF document that comments on the trades I have done as well as the trades I am looking at for the future.

As part of this communications process, every year in early January, I do what I call the “ten best dressed list.” I look back over the previous year, trying not to be biased on what I traded, and it’s usually not ten charts but around that number. Sometimes eight, sometimes fifteen. But the idea is just: “Oh, that was a really good chart. That was really a classical example of what charting is all about. It was a pattern, it was clear, it was big… it was on the weekly chart, it was on the daily chart, it broke out clean and ran the distance, never challenging the entry….” My intent for this annual best-dressed list is to identify the best examples of classical charting from the previous year.

Doing this every year also brings me back to the center. It says “this is what I need to do as a trader.” Because without a clear reference point I’m likely to drift. I don’t want to drift. I want to bring myself back to what I really need to be doing. And that is looking for those patterns that are going to be on that list, because that is where my money is going to be made.

JACK SPARROW: So the best dressed list is like a north star for your profitability.

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PETER BRANDT: Yes, I would say that over the years about 50% or more of my net profits have been from chart patterns that ended up on a best dressed list. It also goes back to controlling risk, and getting to where my head is in the game. When my thinking is ahead of the game, then I can see something on the charts and say, “Okay, this market just can’t be set up any better. I know this chart is going to be on the best dressed list.” Intuitively I just know it. Of course, there are times when my intuitive thinking proves to be wrong.

So because I focus on finding big chart patterns, I am in a position to identify situations like that, and the chart breaks out a certain way, and the way it breaks out technically provides an opportunity for very small risk (chart risk), and a number of other factors line up. That’s when I say, “Back up the truck.” I even have a recording on my computer, the ‘beep beep’ noise of the truck backing up. I sometimes send it to another trader I work with – when I see something really good, I send him the link to the beeping truck.

So I get the trade set up, and the truck is beeping, and I say “I’m not going to risk 50 basis points… I’m not going to risk 100 basis points… I’m going to risk 200 basis points.” Not only that, but because of the chart risk I can have four or five contracts per unit of capital, where typically I may only be trading one contract per unit of capital

JACK SPARROW: Because you’ve got such a narrow band.

PETER BRANDT: Yes. Then we get a good strong day… it’s a good strong bar that breaks out and holds the breakout… the market may slightly back off for two or three days and volume just dries up to nothing… then you get what Wyckoff called a hinge day, super-small range day… a close in the middle of the trading range where you find out there was no volume at all… then I put some more on.

It is getting two or three trading situations like this that can give a trader a 100 percent or better year. And it has been market setups like this that have given me my best years. For me, I have not had great trading years because I was right fifty or sixty percent of the time. I have had the really great years when I was able to exploit two or three trades where I was really able to lean into the trade with my shoulder and push. It’s those gems that really pay the dividend. I know that if I’m going to finish with better than a fifty percent return in a given year, it means I caught some really nice trades.

So, I always anticipate that around the next corner there’s going to be another great trade. I also anticipate that each and every year will offer me at least 10 charts that can wear the title of being on the best dressed list. And most years this happens, but not all years. I have to admit that there have been some years when either the really great trades did not happen, or they did happen and I missed them. I have been in a drought in recent months for really good trades.

JACK SPARROW: Back to this idea of being centered – what are some of the dangers that take you away from the center?

PETER BRANDT: Bad spells come and go naturally in markets. What I don’t want to do is add to bad markets. In my way of trading I tend to look at markets a certain way, analyze markets in a certain way, and have certain ways I get in and get out. So it’s possible that the way I trade is out of sync with the markets. But it is also possible that I am out of sync with the way that I’m supposed to trade.

That is the quicksand I have to stay away from. I have to make sure I execute my game plan in the right way, which is just a matter of being disciplined, always questioning, “Is this a trade I ought to be doing,” not reading anything into the chart that is not there. As *Reminiscences of a Stock Operator* talks about, just reading the tape.

There are some trades that fall into a gray area. If you are a discretionary trader, which I am, you are going to have a certain number of trades that don’t fit neatly into a box. What do you do with those? You have to pay attention to the trades you have on.

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The real opponent of a trader is himself. Not the markets, not other traders down the street, not some commercial house – my opponent in the market is Peter Brandt. Am I doing what I know I need to do to put myself in a position where I know I can either be down six percent or up a hundred.

MIKE McDERMOTT: Going back to something earlier… you talked about having the "license to fly" when you left the advertising agency, and following that, the point of critical mass where you felt you had truly become a trader. During that build-up phase, you had Campbell Soup as a customer helping to cover your bills. How did the financial stability of having that income affect the trading decision-making process?

PETER BRANDT: It was huge. The Campbell Soup income is what helped me become a consistent performer. By consistent performer, I don't mean someone who is hitting their number every year. To me, a consistent performer is someone who can stay in that acceptable minus-five to plus-100 range and do what they need to do.

Consistent performance isn't necessarily based on the dollars you make, but on the things you need to do to perform – repeating and repeating what you think are your best practices. The goal is to be a consistent performer and then let the money take care of itself.

This is a roundabout way to answer your question. But where the financial stability becomes important is that, if I feel like I need to make $4,000 this month for living expenses, or $8,000 this month or what have you… that my tax bill is due or that I need to put a new furnace in my home… or that my wife wants a new Subaru Outback… all of a sudden I've taken my trading capital and put dollar signs on it related to things that need to be bought. I've attached emotion to my capital. In my mind it is so important not to have any emotional propping up of trading capital. Trading capital needs to be just numbers, a way to keep score.

The subject of money has emotion. Money has as much emotion for a lot of people as do their wife and their kids and their parents. If you want to get people emotional, bring up the subject of money. So if you're not just cold-hearted – and I'm not cold-hearted – then I have to find ways to move myself away from all the emotional stuff that sticks to money. Money just seems to have emotion-attracting velcro on it. I have to find ways to cut the velcro off. I have to view my capital as just part of the game. The degree to which I am emotional about my capital can be the degree to which I start trading defensively. And defensive trading usually goes in the wrong direction.

I also even need to detach myself from what I'm trading. I'm not trading corn, I'm trading price. It is also important for me to detach myself from price itself. It shouldn't matter if I am buying beans at fifteen bucks or six bucks. All that matters is, are beans going to go up? If so, who cares where the price level is. Some of my worst trades have been talking myself into buying something that was cheap.

I do not want my trading capital to be assigned in such a way that: "This chunk has to go for rent, this chunk has to go for a car, this chunk has to go for education." I want to get rid of all that, which is why it was so important to have the Campbell Soup revenue at that stage in my career, or to have had that back-up game plan of returning to advertising, because then I don't have to worry about needing to use trading profits for living expenses.

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Part V: The Toughest Trade

In Part IV of this series, we learned about protecting profits, staying centered, the characteristics of a big trade, and who a trader's biggest opponent is in markets.

In Part V we hear about Peter's experiences as a light aircraft pilot… his most interesting trade… his toughest (most emotional) trade… and key principles to avoid compound errors (making it back from "the wilderness").

JACK SPARROW: Speaking of "license to fly," you've mentioned that you are a pilot.

PETER BRANDT: I've owned three aircraft in my life. I started with a 1951 Piper Tri-Pacer, which was the first Piper that had tricycle gear. It was a fabric aircraft, and had a sink rate of a lead weight, and a high speed for touchdown. It was a lightweight plane, a four-seater, and the thing was just fast. It had a speed of about 135 knots.

I bought the Piper with my wife's cousin, who was an Air Force pilot. We both lived in Chicago and he was based out of Michigan, so he needed a plane to fly over to his base. So he said, "Want to learn how to fly? You can buy half of the plane." So I learned how to fly that way. Then I bought a Cessna 172, and then a Cessna 182. I wound up selling the Cessna 182 but I should have kept it. Used aircraft just keep going up in value every year.

Flying was expensive, but it was great for me because I wrote most of it off. When I moved my family to northern Minnesota I would fly down to Chicago, and I could land at Miggs Field right in downtown Chicago. I could literally walk to the Board of Trade from Miggs Field. It was a ten-block walk.

In Minnesota we lived on a lake, and I had a neighbor with a snowplow. He would plow an airstrip for me on the lake. In the winter time I would take an ice auger and auger down my straps, so I could strap it down and keep the plane right on the ice. I didn't have floats on it, but I had floats on the 172.

MIKE McDERMOTT: Can you put floats on it?

PETER BRANDT: Oh yes. I wound up selling it in Alaska. It had what is called a STOL kit, which stands for Slow Take-Off and Landing. It gave you an extra curvature off the back of the wing.

If it was perfectly still and there was no wind, winter-time, early morning or late evening, no thermals, I would see how slow I could be going at the point of touchdown. I used to do that just for fun. I could get it down to 38 or 39 knots. We would take it out and see if we could land it with just the trim tabs.

JACK SPARROW: So did you find any parallels between flying and trading?

PETER BRANDT: No, I forgot about trading when I was flying.

JACK SPARROW: Just a beautiful escape.

PETER BRANDT: A marvelous escape. I clocked a lot of hours, flying just about every day. We lived up in Nisswa, Minnesota, and I had the option of landing on the lake in winter time – which really scared the ice fishermen, because when you landed on the lake the ice would crack. It's thick enough that it was not going to break, but it does crack. And these ice fisherman would get so mad at me.

Then we had a grass strip which was five miles away, and a really nice airport with an 8,200 foot main runway that was 25 miles away. I kept the plane in a hangar there.

JACK SPARROW: Tell us about the most interesting trade you've ever had.

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PETER BRANDT: It was 9/11, when the first tower was hit. The futures were operating in one of the buildings within the World Trade complex. After the first tower was hit, the trading was halted and then it briefly reopened, and I traded gold. I have a time-stamped order after the first tower was hit. Just the idea of trading gold, considering what was happening, seems to me a fascinating thing.

When gold re-opened six days later I think it was $10 or more higher – which was a big move at the time – and I took my profit and walked away from the trade. I considered myself lucky, and the reason I walked away from the trade is because I didn't like the idea of making money on a lot of people's suffering. I decided I wouldn't sit and exploit the market any further, and I can't even remember what the market did after that.

But I remember taking my profit thinking, "I've just made money on the lives of a lot of people. I'll take my profits and I'll thank the market and walk away." So that was probably my most interesting trade ever.

JACK SPARROW: What was your toughest trade ever?

PETER BRANDT: The toughest trade ever was crude oil. It was the first Iraq war, January 16, 1991 when the bombing started. I was long crude when the bombing started – the evening of January 16 – and I was thinking, "Man, this is going to be sweet." Crude oil was trading a few bucks higher in the after market, but by the time the pit trading started the next day, the trade opened something like 700 points against me. Prices closed on January 16 somewhere in the area of $30 per barrel. Then the war started, and prices opened in the pit on Feb. 17 about 700 points lower.

I remember thinking the night the bombing started, "This is going to be payday." Prices were trading that evening on the curb $3 or $4 higher right after the bombing. But by the time U.S. markets opened, crude had in effect declined ten bucks off the previous evening's curb price.

JACK SPARROW: Was that your most emotional trade?

PETER BRANDT: That was just the hardest trade – my biggest, quickest single loss. I don't think the size was very big, it was just a trade I thought I'd be making four or five thousand dollars per contract on, and I ended up limping out with a six or seven thousand dollar per contract loss. Oftentimes the emotional hit from a trade is tied to an earlier expectation for the trade.

JACK SPARROW: As you said earlier, you know there will be ten great patterns each year and the year after that. Does that help put those kind of setbacks in perspective, or the times when you feel "out in the wilderness?"

PETER BRANDT: There are things that stand out as principles I really need to hold to. One of them is that I need to forgive myself very quickly when I do something stupid. I can sit and hold previous mistakes over my head, and mistakes will compound if I do that. You have to be able to clear your conscience of the mistake you just made. If you beat yourself up and hold onto something, you're going to make another error.

It is inevitable that one error will lead to another error in this business. So you have to flatten yourself out emotionally. And until you do, you just have to go back to small positions until you can build leverage back up. I've been there before, and I'll be there again. In fact, I am there right now as we are speaking.

But you've got to have confidence in yourself, and in what you've done, in order to come out of that wilderness. Otherwise you'll change the way you trade – and then you won't have a clue where you are. Because what if you change the way you trade, and it works for a month or two, but then the new way of trading goes into the wilderness too. What do you do then?

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The only way for a novice trader to make it as a trader is to make a lot of mistakes, many mistakes more than once, until they figure it out and say, “Okay, this is the way I’m going to trade.” And it may not be the way other traders do it. In fact, it really cannot be exactly how another trader trades, although it is certainly possible to admire how other traders do it. I can look at how another trader trades and say, “That’s a thing of beauty. That is gorgeous how that guy does it.” But it’s not the way I do it. You live and die with your own way. That is what every professional trader does. That’s what you Mercenary guys do.

JACK SPARROW: Right – it’s about synthesizing knowledge and great ideas, and then letting your own style emerge.

PETER BRANDT: You know, I would love to be your age and know as much as you guys know. The opportunities are going to come your way. You’ll just stumble upon them. Like the Commodities Corp opportunity that came to me – I wasn’t looking for that when it came. Homestake Mining, I wasn’t expecting that… things will just come your way, and I think you’ll recognize them.

MIKE MCDERMOTT: We’ve got our eyes open…

PETER BRANDT: I was 35 years old when my Swiss Franc trade happened. It all really started for me when I was 35. I think you guys will have an opportunity to manage a billion dollars, if you want to. Or if you want to, keep it at $200 million and have fun and keep it small, without the headache of having to hire an H.R. director.

MIKE MCDERMOTT: That will be a fun decision to make!

PETER BRANDT: I think it will happen. You’ll be able to manage a large sum of money, if that’s what you choose to do. You do it smart, you’re astute, you have a good approach and good risk management… keep doing those things and you’re going to get noticed by people who can write out large checks.

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Part VI: Commodities Corp

In Part V of this series, we learned about Peter's experiences as a light aircraft pilot, his most interesting trade, and his toughest, most emotional trade — along with key principles for making it back from "the wilderness."

In Part VI we hear about Peter's experience running money for Commodities Corp., the Mount Olympus of institutions that brought forth so many trading legends from its fold. We also hear about Peter's experience evaluating other traders, and methods for building excellent composite performance. (Hint: Focus on the risk.)

JACK SPARROW: You've already mentioned the Edwards and Magee book was a major influence in the early years. Who are some of the others who have really influenced you over the years, or memorably shaped your landscape as a trader?

PETER BRANDT: Before Edwards and Magee there was Richard W. Schabacker, who did the heavy lifting that led to the Edwards and Magee book. Schbacker had penned a manuscript in the 1930s. That manuscript had not been printed when I became a trader, but I obtained a photocopy and could read firsthand where the Edwards and Magee material originated. So Schabacker influenced me a lot. From a philosophical point of view, talking about the nature of trading and speculation, Jesse Livermore was a really big influence.

Then, when I was at the Board of Trade, there was a Cargill trader named Dan Markey who was just brilliant. His focus was trying to find the seasonal high and the seasonal low in the grains. And he would only make two calls a year! That was an influence from the standpoint that you don't have to be involved in the market every day. You can try to look at the market from the standpoint of an annual high or an annual low, which could then set you on the path as to how you interpret shorter term signals as you get them.

So Markey was a big influence, and I think Richard Donchian was the other big influence –

JACK SPARROW: The father of trend following.

PETER BRANDT: Right, the father of trend following, and really the father of the whole managed futures industry. He played a very big role in the growth of futures. He is truly a legend in the futures business. Our industry owes much to him in many regards. He was a researcher first and foremost, and studied and wrote about many things. He wrote about a bull market needing to make a new high every X days to remain healthy. He also created something called "the weekend rule' – something that I have incorporated into my own trading.

I've also really enjoyed everything I can read about the markets that speaks to the human battle that it really is. The battle that goes on in the human soul – that fight against fear and greed and natural inclinations. When I traded money for Commodities Corp, I had the chance to talk with a lot of interesting people – good traders who didn't necessarily trade the same way, but again were interested in talking about the philosophical side of trading. And mostly the risk side of it.

Mostly though, I've just been a grinder – figuring out my own way in the markets. I was never an understudy to anybody, so to speak, other than perhaps Edwards and Magee. I have really just developed my own approach as time has gone on.

JACK SPARROW: Let's talk about Commodities Corp., which has a "Mount Olympus" type reputation in the history of trading given how many world-class money managers cut their teeth with them. Can you tell us about your history with Commodities Corp and your trading experiences there?

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PETER BRANDT: I don't recall the exact origins of the connection. But I remember going to Princeton, New Jersey where they were based, flying into the Newark Airport where they had a limousine waiting for me. I had never been to Princeton or much outside of Newark – what a gorgeous state. I think it was 1985 or 86.

JACK SPARROW: What made Commodities Corp invite you into their fold?

PETER BRANDT: I think they had heard about me through my writing. I have always written about my own trading, placing my thoughts on the market into the public domain. Either one of their traders or someone in their management structure decided they liked my ideas.

So I was invited to do an interview with a number of their people in Princeton. The interview focused on how well I knew my own trading approach. That was what the interview was really about: Is this a guy who knows what he's doing, not from the standpoint of whether he'll be an outstanding profit contributor, but does he know what he's doing from the standpoint of how he will react to different situations in the market.

They showed me their trading rooms, and they had a lot of people there, but there were also a lot of traders who didn't trade on the premises. They traded from wherever they lived, but they were still Commodities Corp traders, and many had offices there. I remember I was shocked at how many chart books were on the desks. Many of the Commodites Corp guys were chartists.

JACK SPARROW: And that influence was from Michael Marcus and others who were very profitable using charts in their trading?

PETER BRANDT: Exactly. Many of these traders were classical chartists. We were singing the same song – head and shoulders, retracements, breakouts and so on.

JACK SPARROW: So how did they set you up?

PETER BRANDT: The way that they did it back then was, if they liked you and and thought you had the potential to be part of their stable of traders, they would allocate their own proprietary funds to you. I think it started out at around a hundred thousand to half a million dollars, and they would watch you very closely.

Then there were benchmarks you would have to hit over a two or three year period. I don't remember the numbers exactly, but as I recall the two-year average annual rate of return needed to be something like 24 percent. If a trader didn't hit the two-year performance goal, then the evaluation was extended to a third year with a different compounded ROR target.

Then they looked at retracements and drawdowns, and at any given point you were not allowed to have a drawdown of more than 29 percent, I believe it was. They ran a 29-day moving average on your equity.

JACK SPARROW: They traded their traders.

PETER BRANDT: That's right, they did. Plus you had to call in every day when you wanted to trade something, because they had a desk that tracked what their position limits were. They didn't want to exceed their limits, and they were usually in a reportable position to the CFTC. I don't ever remember not getting permission to trade the markets I wanted to trade.

They put you through what was called a "Trader Evaluation Program," and if you hit your numbers in this first cycle you went through the second cycle. After the first cycle they upped the ante and you would get funded for more. After the subsequent cycle, at that point you were no longer in the TEP program – you had graduated to being a full Commodities Corp. trader.

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I never considered myself in the same light as some of the famous guys like Paul Tudor Jones. I was just a trader from northern Minnesota. But I did trade a lot of their money then and retained a relationship with them.

They were wonderful to work with, though you had to put up the numbers. If you didn't put up the numbers, they wouldn't necessarily fire you, but you would go through a probationary period. They really had the whole thing thought through in advance, well before anyone else did in the same way.

JACK SPARROW: Do you remember your numbers during the early years trading funds for Commodities Corp?:

PETER BRANDT: Actually I do. In fact, I recently saw the file when I was cleaning out a closet. I did about 13% the first year, 31% the second year and 24% the third year. My compounded ROR the first three years was just north of 20%.

JACK SPARROW: You are now in a position of evaluating other traders yourself, is that correct?

PETER BRANDT: I am, yes. I really believe that traders – not buy and hold investors, but good traders – are going to be incredibly valuable in the years ahead. I also think that managed futures are right on the verge of exploding as an asset class. Managed futures are very underrepresented in the portfolios of most investors. I would suggest to most anybody who is retired, over 50, or has otherwise accumulated a large sum of money, to consider a diversified allocation to managed futures or hedge funds in their portfolio. My own personal goal is to move 80 percent of my retirement IRA-type assets into managed futures – managed by traders other than myself.

JACK SPARROW: What are some of the characteristics that you look for in a good trader?

PETER BRANDT: When analyzing data for investing in a trading program, most people put too much focus on the upside performance side of the equation. They look at whether the trader made 30 percent last year or 15 percent and so on, and create their list based on rate of return. As a trader myself I understand how important performance is. But if you don't have strong risk management protocols, you will never put yourself in position to have a long string of good years.

So I went a different way. I acquired data on Commodity Trading Advisors, or CTAs, from Barclays and other sources and spent three months developing an algorithm and a set of filters primarily based on risk. The traders I wanted didn't really need spectacular performance, or even a year above 20 percent. But what they had to do was demonstrate an extraordinary ability to manage risk. The algorithm looked at risk-adjusted performance and the ratio of worst drawdowns to average rate of return… the average annual worst drawdown versus average annual rates of return, duration of drawdowns, and so on.

There was also a diversity component, with points that could be assigned for slightly different trading approaches or time horizons. Some of the candidates are scalpers; some are position traders; some are trading forex; one of the finalists on my lists is even a day trader of the S&P 400 contract.

Finally I took a look at what happened to traders when they saw a big jump in money under management. Did their performance take a hit, or did it hold steady? For most everybody I think there is that point where performance reaches a peak based on assets under management. Traders get tapped out on how much they can manage, and then performance goes flat, or even heads off a cliff.

JACK SPARROW: That's when they start managing for fees rather than real performance.

PETER BRANDT: Yes, that can be the case. They start trading not to lose, as opposed to trading to win. So there were a lot of things we looked at, a sort of rat maze that we pushed the performance data of all these traders through. Then we took a harder look at the finalists: Did they have any regulatory complaints … were there any oustanding issues that had to be described in their

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performance… for instance there was one trader with a very big drawdown, but it was eight years ago. So we went around and talked to these people: "Tell me about that 37-percent drawdown you had in 2003, what was that all about."

Going through this process, we wound up with a group of ten or so traders that was just a great group. And what is remarkable about this group is how they actually do as a portfolio once you take a look at composite performance: "What would have happened had I given these people funding five, six, seven years ago."

I know that past performance is no indication of future returns, but you have to go on something. You can't just pick straws or throw a dart. The reality is that past performance is an indication of how a trader trades. It doesn't indicate that a trader is going to repeat and repeat, but it's the best thing you have to go on.

JACK SPARROW: Were there any measures you particularly relied on?

PETER BRANDT: Generally speaking we took a look at something called the Calmar Ratio, which is an acronym for "California Managed Accounts Reports." The Calmar Ratio divides average annual rate of return for 36 months by maximum drawdown over 36 months, recalculated on a monthly basis. We made some modifications to the Calmar Ratio in our analysis of traders.

The traders we liked had Calmar Ratios from 1.5 to 3.0, meaning that, at a ratio of 2.0, an average rate of return was double a worst drawdown.

JACK SPARROW: So just to put that in layman's terms: If you have a Calmar Ratio of 2.0, and an average annual return of 20%, that means your worst drawdown would have been 10%.

PETER BRANDT: That is correct. And the traders were all in that range, but when we blended them together something interesting happened. We didn't try to negatively correlate performance, and total performance was a straightforward calculation. There was no change in the composite returns of the group. But the BIG change was in composite drawdowns and magnitude of drawdowns. Those changed dramatically, where all of a sudden the worst drawdowns of the group as a combined portfolio dropped into the 2 to 3 percent range – and in 2010 there were no drawdowns at all, when measured on a month to month basis.

JACK SPARROW: And that is because the traders in the group were so good, someone was always performing. When one was temporarily behind, another was always stepping up.

PETER BRANDT: Exactly. They had their drawdowns at different points in time. So while the net returns were still there, the average drawdowns leveled off. And not only that, but the composite length of peak-to-valley-to-new-peak drawdowns shortened dramatically. While the average for each individual trader was around ten months for peak-to-valley-to-new-peak – ranging from six months to 27 months – the longest drawdown for the group as a portfolio was only three months.

I think a focus on risk-adjusted performance is a different way, an exciting way, of looking at combinations of traders. It is a concept that has great merit for institutions and large investors. As mentioned earlier, most people in managed futures have mainly looked at the performance side, not the risk side or the drawdown side.

For me, the bottom line of it all is not about identifying traders who have had stellar returns. The bottom line is about finding traders who have managed their capital well, and have not gotten whipped too bad when things have been rough.

JACK SPARROW: And of course, having both (stellar returns and excellent risk management) isn't a problem either!

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PETER BRANDT: Definitely not a problem. But first and foremost, you have to guard your chips. Your capital is like inventory for the retail business. If you are a retailer with no inventory, when people come into your store they won't buy anything. There won't be anything on the shelves. So you have to pay very close attention to your risk.

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Part VII: Debunking the Sharpe Ratio

In Part VI of this series, we heard about Peter's experiences running money for Commodities Corp, as well as his methods for evaluating other traders and creating superior composite performance.

In Part VII we uncover the serious flaws in the Sharpe Ratio, a popular performance metric, and talk about why it is so problematic. We also discuss the difference between managed futures and mutual funds, advice for new traders, and more on the "upstream swim against human nature."

JACK SPARROW: On the subject of evaluating trader performance: There is a very popular method known as the Sharpe Ratio. We know from previous discussions that you're not a big fan of that measure.

PETER BRANDT: I hate the Sharpe Ratio. I think it is not only worthless for evaluating futures traders, but it actually can be detrimental to the search.

JACK SPARROW: Given that the Sharpe Ratio is so popular, how about sharing as to why you dislike it so much.

PETER BRANDT: The Sharpe Ratio gives the highest marks to traders who basically have the same rate of return each and every month. And so, if a trader does 24% in a year, the way to get a great Sharpe Ratio would be to spread that out at 2% a month. The Sharpe Ratio will reward a trader for that because he has very little difference from month to month. It's a measure of standard deviation from the norm. People who use the Sharpe Ratio calculate an average and then look at the deviations from that. And a trader gets penalized by the Sharpe Ratio for not having consistently equal months.

But for me there's no difference between, say, a trader that does 2% every month, and a trader that does 12% in two months, but doesn't do anything in the other ten. The latter to me is a perfectly acceptable way to trade, and in some ways I even like that trading result better.

JACK SPARROW: And the trader who has "steady eddie" returns of the same size every month – that's kind of the Bernie Madoff profile, or someone who is collecting naked options premiums. That artificial level of stability is a little frightening.

PETER BRANDT: Exactly. You wonder where the performance is coming from, and you have to take a look at how they are trading. If there are any question marks as to where the performance is coming from – like if they are selling options – you have a chance for a disaster year, where traders did great for a number of years but then didn't account for a big event. And the big event grabs them.

Whereas the guy who does minus one, plus one and so on, and then has a really big month… that to me is a trader who really knows how to manage risk and exploit opportunities when they come, and in the meanwhile he's waiting in the weeds. The Sharpe Ratio will brutalize that trader!

JACK SPARROW: Because the Sharpe Ratio fails to distinguish between upside volatility and downside volatility, and thus penalizes upside volatility in periods of true opportunity.

PETER BRANDT: Exactly – upside volatility is penalized if it skews away from the norm. It is interesting to me that the marketing people and the packagers of CTAs pay so much attention to a ratio that I think is not a good ratio to follow.

JACK SPARROW: Why do you think the Sharpe Ratio is popular? Would you agree it is because people crave stability to a greater degree than is healthy? That they aren't willing to embrace the uneven nature of the market process in generating returns?

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PETER BRANDT: When volatility is low it's easier to package and market a track record. You can put a prettier bow around it. And much of that marketing is done by people who have never really had their net worth on the line in markets. They don't know what that feels like.

I know there are traders in that business as well, so I don't want to blanket criticize the business of packaging traders into multi-trader funds on the basis of Sharpe Ratios. I don't want to cast that wide of a net across this corner of the industry. But in general, I think the concept of relying on the Sharpe Ratio to evaluate trading talent is not the way to go.

Instead, I believe the way to go is to focus on traders who have had good performance, but also have demonstrated a tremendous ability to manage risk during their tough periods. I want to identify traders who have had shallow drawdowns and a clear ability to come out of those drawdowns – sometimes quickly, sometimes not so quickly, but they come out of them. And as long as they stay alive, good traders will find a way to make money again. So my focus is on good traders who really know how to manage risk.

Combining traders that have solid performance with extremely controlled drawdowns at the end of the day is going to provide double digit rates of return – sometimes very high double digit rates of return – with low asset volatility overall. And when there is a bad year it is not going to be a crippling year.

By comparison, take a look at the stock market. Imagine running a Calmar Ratio on the S&P 500, with or without dividends. There is no stability in the stock market whatsoever! On the basis of the Calmar Ratio, the stock market is an example of asset volatility on steroids.

JACK SPARROW: It has always amused me how the futures industry has been portrayed as this high volatility wild west, whereas to me, being in mutual funds has always been the true wild west. Mutual funds have always struck me as the equivalent of a roller coaster ride in Vegas, with no risk control whatsoever.

PETER BRANDT: Compare wealth managers in the stock market to good commodity traders in the "wild west" of futures markets as you say. The stability and solid risk management is taking place in the futures markets.

JACK SPARROW: It seems like the extra risk and leverage available in commodity markets has convinced the managed futures industry to take stability and risk management seriously, whereas all too many stock managers come from the perspective of "stocks will always come back" and don't much worry about risk at all. As "investors" with an artificial sense of safety – because stocks always go up "in the long run" – the stop loss and other risk management tools are alien concepts to them.

PETER BRANDT: Yes, and there is one more factor that adds to that to some degree. The background of futures managers versus the background of big stock portfolio managers is very different. The futures markets have never had an MBA fast track, where you come out of Harvard with your MBA, get a good job on Wall Street, and three years later you are managing a billion dollars.

That doesn't happen in the futures industry. Futures managers by and large started out with proprietary capital. They started trading with their own bucks! They learned risk by trading very transparent markets and they knew day by day and minute by minute how they were doing. They were taking risks with their own money. They learned risk management because of that.

In futures it's a group of people who tend to be Mercenaries, like you guys. Guerrilla warfare traders who never looked for the Air Force to back them up.

JACK SPARROW: You have had tremendous success over the years by any measure, and you've also shared how the traders' greatest battle is with himself. What would you say are some of your own personality characteristics that made you successful as a trader?

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PETER BRANDT: First of all, persistence. I just don't give up. Also, from the beginning I was a little bit risk averse. Looking back, some of the trades I made don't appear to fit that profile. On the surface they looked like risky trades. But in my heart I knew the situation at the time, and I didn't feel they were very risky trades.

So I have been somewhat risk averse. I haven't been a wild gunslinger: "Made a million, lost a million" and so on. I always wanted to have a bad year come out as a breakeven year, and have a good year be one with really great performance.

JACK SPARROW: And even though you are risk averse, you have always had the courage to go for the gusto and book those triple-digit gainer years when the opportunity was right.

PETER BRANDT: Yes. And going back to personality, they have those aptitude tests that measure your strengths and weaknesses and tell you what your career should have been: Dancer, school teacher or what have you. Whenever I have taken those tests, "engineer" scored very high, to the point that I sometimes wonder if I should have been an engineer.

I think my mind tends to work very sequentially. I want to know how my trading plan is put together: Where every nut is, where every bolt is, what pieces move, what pieces don't… for me it has always been very important to have a tremendous comprehension of what I was doing in the markets.

I'll be the first to say that I do not think my trading plan is a tremendous trading plan, in fact, I think it is probably very average. There are probably a lot of people who have trading plans that on paper are superior to mine, yet they don't do well in the markets, and may in fact wipe out. Because it is not just the trading plan, but even more importantly the execution of the plan that counts.

JACK SPARROW: So execution is one of the main things you see as making that difference?

PETER BRANDT: Yes, but there is a slightly different way to look at the same idea. I have made every mistake in the book. I have thirty years' worth of mistakes in trading. There are very few I haven't made to some degree or another. But I am very introspective about the markets. I think deeply about the markets and about my trading plan.

For example, I constantly evaluate what I have done in the last month. Every three months I do a formal evaluation to better understand every trade I did. I am very critical of past trades – not that it changes the results, but for me it is how I learn. On an annual basis I really tear my trading up, and look at a lot of different metrics. So I am constantly evaluating my trades. As a result I have a trading plan which is very defined, and I try hard to follow it. That has been a major contribution to my performance overall.

JACK SPARROW: Just in general terms, what advice would you give someone who is really hungry and excited about building their career as a trader? Any words of wisdom or suggestions as to what they should focus on?

PETER BRANDT: I think the biggest mistake beginning traders make is overleverage. The single biggest mistake is they bet too much.

JACK SPARROW: So start small.

PETER BRANDT: Yes. Very small. You take the total amount of money you have and break it down into very small units, and that's what you risk on a trade. Because you're going to make mistakes. I'm convinced that anyone who becomes a good trader makes a lot of mistakes. In fact, good traders become good traders through their mistakes.

JACK SPARROW: You have to go through the gauntlet to get that internal knowledge.

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PETER BRANDT: And you will learn. But you have to go through it and make those mistakes. It is how a person evolves as a trader. It will take a while to learn it. You will need to have suitable assets to trade with once the steepest part of the learning curve is done.

JACK SPARROW: It seems a lot of beginning traders underestimate the amount of time it takes to advance through the learning curve… to get to where they really know what they are doing.

PETER BRANDT: There are some people who can really be superstars and learn the trading game quickly. But most professionals I've had conversations with, including you guys, would probably say the incubation period is three years. It takes a few years to say "Okay, I have a real comfort level with what I'm doing." There are changes that will be made to the way they trade after that, but at least at three years they have made enough mistakes to have figured out the game.

JACK SPARROW: That seems pretty reasonable when you look at other professions. Doctors and dentists and psychiatrists and so on have multiple years of schooling, and good traders can earn many multiples what they do.

PETER BRANDT: And why would it be any different? A doctor might have four years of medical school, and then another two years for a specialty. Why should it not take a trader a comparable amount of time to really figure out what they are doing?

The other thing I would say to a new trader is, they should have a solid grasp of what a "trade" is specifically for them. They should not come into a new day and say "Well, I wonder if there's a trade for me today?" or look at a market and say "Hmm, well is there a trade here for me or isn't there?" They should strive to reach a point where if they are not 100% sure there is a trade, or at least 80% sure there is a trade, they don't do anything at all.

Another way to put it is knowing their 'hit zone' as if they were a batter in baseball. If they don't hit high and outside pitches very well, they need to know that. They need to know what type of market conditions represent high and outside. Maybe they are good at hitting curveballs inside and low, and that is their sweet spot. They need to figure out what trades represent that equivalent sweet spot. And it takes a long time to work these questions out.

JACK SPARROW: Finding out for themselves what fits them best.

PETER BRANDT: I've always said that if a person doesn't know him or herself well, their character and personality traits, they ought to just trade for a couple years. Because they are going to know themselves real well after that.

On a personal level I know that I tend to be impatient. I've learned that about myself through trading. The reality is that my personality traits tend toward impatience. But it is not okay for me to trade impatiently. So I know going in that I must wage war against one of my basic traits when trading.

JACK SPARROW: Everyone has to be intimate with their weaknesses as well as strengths.

PETER BRANDT: Absolutely. That is where the upstream swim against human nature comes in. You have to know what areas of your character, your temperament and your personality are likely to be net negative contributors to your bottom line over time. Those are the personality traits you are going to have to battle with.

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Part VIII: Peter Interviews Jack and Mike

And now, the finale!

In this final installment of the "Interview With a Trading Legend" series, Peter poses questions to Jack and Mike, with topics ranging from matters economic and philosophical, to life outside trading, to perspectives on mechanical versus discretionary approaches.

PETER BRANDT: Can you ever imagine not being a trader?

JACK SPARROW: To give some background: There are two reasons I fell in love with trading. First, I was enthralled by the idea of "making money by thinking." Second, the world is such an inherently fascinating place that trading served as a gateway for learning about everything else.

Prior to discovering markets, I had never conceived of a business where, to be truly good at it, you could benefit from learning psychology, math, history, engineering principles, analogies to physics and biology and so on… it is just the most fascinating game in the world.

So I have a hard time imagining not wanting to be a trader because I am so in love with the game. But if that period ever came, where I felt I had accomplished everything I sought out to do in markets, I would move on in pursuit of some other even bigger game. I have sometimes played around with the idea of, say 30 or 40 years from now, tackling the deeper waters of philosophy, or further exploring the human mind or something like that.

But my love of trading remains rooted in "truth being stranger than fiction" and the world just being an intensely interesting place – so at least for now, I can't conceive of any other game that holds as much appeal.

MIKE McDERMOTT: From a similar standpoint, I have always been both an analytical person and a very competitive person. I have older brothers and younger brothers, and whether it was sports or a game you play after dinner or what have you, mom would ask, "Does it always have to be a competition with you guys?" And the answer was yes, it does!

I love the competitive aspect of trading. Not necessarily always competing against other traders, though that is certainly fun, but "How did I do, how could I have done, and how could I make it better." Because all the lessons are applicable for the next set of trades.

So I can't really imagine another line of business I would rather be in… the other thing about trading is that there is always something new happening. There is always something new to analyze, a different set of scenarios – every day is different. There are the same principles that you apply, but there are no boring days. So I love that there is such a dynamic range of vehicles and patterns to follow.

JACK SPARROW: The ultimate game…

PETER BRANDT: You asked what personality traits are attributed to success: I think one of those is competitiveness, and I really relate to what Mike just said. My wife says, "Can't you do anything with your sons without making it a match?" When they first beat me at ping pong it was because they beat me – I wasn't going to let them win. Everything we do is competition. Traders are naturally competitive.

Here is a philosophical question, or rather a statement, posed by traders who are a lot smarter than me: "The purpose of capital markets – their main function in history – is to redistribute wealth from the many to the few. And if that ever ceased to be, capital markets would cease to exist."

How do you react to that statement?

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JACK SPARROW: I disagree that the main purpose of markets is to redistribute wealth from the many to the few. You can argue that has been a consistent outcome of having capital markets, but it is definitely not the purpose in my opinion.

I would say there is a reason why, when you look at all the countries in the world that are successful, they wind up having exchanges, or some similar means of allocating capital and facilitating price discovery. I further think, if we were to explore other planets and find alien civilizations at a comparable development stage to ours, they would probably have some version of capital markets too.

The reason capital markets are so ubiquitous, I think, is because investment capital tends to flow towards the highest rate of return. This spurs productivity growth and helps generate wealth. When someone has a good idea and puts that idea to work, everyone else in the economy can potentially benefit, and capital markets facilitate that.

So for example, when Steve Jobs at Apple made everyone's life better by coming up with iPods and iPhones, investment from capital markets helped him do that (and made him rich). Investors sent Apple the funds necessary to build supply chains and pay for their designs and so on. This is an example of how capital markets distribute savings, in the form of investments, that in turn create productive wealth.

When someone gets rich by building a better mousetrap that saves time or energy or improves quality of life, capital markets help that win/win situation to happen. And that is what I see as the driving purpose, and the reason why the unpleasant aspects of capital markets are tolerated by society.

MIKE McDERMOTT: I would add the actual "greed" side is what drives capital markets in a lot of ways. That gets a bad rap because the social implications of greed really aren't good. But if you look at various industries you can see how that gets complicated.

For example, you could look at the medical industry and say, "These evil drug companies are charging $40 a pill for something that costs them 37 cents to make, which is morally wrong." But without the ability to create profit, nobody would have put the billions of dollars into research and development to create this life-improving drug in the first place.

From a trading standpoint and a capital allocation standpoint, the pursuit of profit actually does drive ingenuity and the process of making life better as a whole. But even with capitalism and markets I feel there is an individual responsibility – not a government one – to look out for your fellow man if you've done well. Make sure that your family is taken care of, then reinvest in the community and so on.

PETER BRANDT: Another question: Are some of the ills we have had in our economic system – the shock waves and so forth – due to the fact of deregulation? Should we go back to an era when bankers were bankers, mortgage brokers were mortgage brokers and so on… a return to those days where the same company can't hold your money, lend you money, put together leveraged deals, and all of those things. Should we go back to a system of separation?

MIKE McDERMOTT: I think that moral hazard is the biggest issue to deal with there, not necessarily the level of regulation. If many of these banks were set up in a place where they had to eat their own cooking – and if they were wrong they got wiped out – the excess risks that were taken may have been much smaller.

But for whatever reason we are in a society where we believe that, for at least a privileged few, you don't have to live with the consequences but you can expect to reap the benefits. For me that is a bigger issue than the regulation question.

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JACK SPARROW: I agree, and I would add there are no simple answers to this question. I believe the people who use extreme ideologies to treat regulation as black and white are part of the problem. On one extreme you have people who think markets should be completely free with no regulation whatsoever, which is crazy. On the other side you have people who think we should have regulation out the wazoo and the government should micro-manage everything, which is even more crazy.

The reality is that we have to apply wisdom and balance on a case-by-case basis with this stuff. You can't have free markets without some form of controls, because if you do that there is no way to stop corner-cutting and predatory instincts from eating the system alive. If we got rid of regulation entirely, for example, imagine trying to buy food or medicine without the FDA. We may not like the FDA as it exists, but imagine if you couldn't know whether there was poison in the food you bought at the grocery store. You have to keep things in check.

But at the same time, as all entrepreneurs and market-minded capitalists know, too much red tape is a killer. An abundance of bureaucracy tends to suffocate free markets.

So the answer, I believe, is going back to a cultural sense of moral responsibility and plain old common sense. In terms of actual regulation, I lean libertarian. People and businesses should be left alone as a general rule of thumb, as long as their actions are not creating a threat to broader society. So I don't have a problem with regulating huge banks, for example, if the hugeness of those banks represents a genuine danger to the economy at large.

A clear example of this is the split between giant banks and hedge funds. If a hedge fund blows up and the investors lose all their money, that doesn't threaten the financial system as we know it. So aggressive hedge fund risk taking should be allowed within reason.

But if an investment bank at thirty times leverage blows up, and threatens to send the entire economy hurtling into recession or depression, then yes those guys should be regulated because they are a major threat to the system. What's more they are not just a disaster threat but a blackmail threat, because the "too big to fail" stamp creates moral hazard in that a giant investment bank can say, "We know we'll get bailed out if these trades go bad, because if you don't bail us out the economy gets it."

For those guys I say yes, regulate the crap out of them – and if they don't like it, let them reduce their size and give up their implied government backing.

The ideal is a King Solomon type mixture, where corruption and moral hazard are reined in and private institutions are allowed to fail. In terms of how that looks, I like some of Paul Volcker's ideas. He had a good balance, but that's why the bankers had him kicked out of Washington.

PETER BRANDT: George Soros has written books on his theory of how world economics works – the closed loop between the economy and the markets and so forth. What do you personally think about Soros' theories?

JACK SPARROW: There are a lot of people who intensely dislike George Soros. He has been painted as a sort of left-wing socialist meddler, part of a limousine liberal elite. I don't really buy into that. His political activism may be questionable in some areas, but on a pure idea basis I think Soros is a brilliant mind. He has had some extremely powerful ideas that deserve a lot more respect than they've received.

If you look back over the 20th century, I believe it was Yale professor Robert Shiller who said, "The efficient market hypothesis is the most remarkable error in the history of economic thought." And Shiller is absolutely right. Efficient market theory is responsible for trillions upon trillions in pain and losses because its assertions are just so out of whack with reality.

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In contrast to that, Soros' concept of reflexivity theory – in which we recognize that markets are about two-way interaction and feedback, with player expectations influencing the game as it goes on – is one of the most succinct and logical descriptions of how markets work that I have ever heard. If you look at Soros' descriptions of feedback loops and boom and bust cycles, you see them play out over and over again.

Furthermore, the 2008 financial crisis (and everything leading up to it) was a gigantic real-time example of reflexivity theory at work, and also a massive example of why efficient market theory is wrong. So I think Soros deserves great credit, not just as an investor and a speculator, but as the champion of a theory that will hopefully edge out and replace efficient market theory over time.

PETER BRANDT: I remember being at the Board of Trade, and the University of Chicago – the preeminent think tank for economics at the time – believing the random walk concept for markets. Meanwhile here I am at a building where you have all these people saying, "If that's true I couldn't make a living!" They were consistently making a living because random walk is false. It's the comparison of economic theory with economic fact. As traders we make money because random walk is a false theory.

JACK SPARROW: Regarding random walk, the thing that blew me away was reading how Paul Samuelson, the godfather of neoclassical economics, was an original investor in Commodities Corp!

Samuelson was not only a huge force behind efficient market theory, he was an aggressive champion of the random walk hypothesis and even preached it as gospel to congress. And yet this very same guy had money with Commodities Corp and Warren Buffett!

As Taleb says, that's like the Pope secretly practicing Islam. It's amazing.

PETER BRANDT: He was preaching and teaching random walk, but with his own pocketbook he was saying markets can be beat.

JACK SPARROW: And Samuelson kind of half justified it by saying "Well, random walk is true for the vast majority of money managers, and only a tiny handful are smart enough to beat the markets long term, so the theory might as well be taken as true."

But that still makes it grossly dishonest to go out and preach random walk as gospel, when he himself didn't practice it.

PETER BRANDT: Another question: What lessons do you take from the fall of Richard Dennis? One of the biggest swingers at the Board of Trade… great trader… not only that but he believed he could replicate trading skills and did so successfully. He trained a whole generation of people who came up and managed billions… and then he basically goes and explodes. What is the practical lesson for your audience there?

JACK SPARROW: Speaking to the trend following school in particular (and various trend followers who blew up or bled out): I do believe that certain trading styles and methodologies can suffer greatly from overpopularity. When there are too many people following a widespread strategy, and not enough differentiation among that active group, the strategy can be degraded to the point of no longer working.

There is some debate on that, because there are trend followers who have been around for decades and haven't blown up. They have adapted and survived, or otherwise ridden out the rough spots, where others like Dennis haven't. So for me the first takeaway would be: Keep tabs on not just your methodology but also its relative level of popularity in the market ecosystem. Where is your edge? How durable is that edge, and how prone is it to replication? How much differentiation do you have? How many others are doing the same thing?

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The other thing is to focus on adaptation as a deep survival skill. Sometimes you have to shift with the times… or alternatively if you don't want to shift, you have to lighten up and cut back on your risk. Cut back and cut back until conditions have moved back in your favor, or until you have pinpointed the problem and solved it.

I think when guys who were longtime success stories go over a cliff, part of the problem is that, instead of cutting back and becoming more contemplative, their past success made them arrogant and bullheaded. They pushed it and forced it when conditions were unfavorable, and wound up in that area of compounding mistakes that you talked about earlier.

So another thing just goes back to self awareness and knowledge of surroundings. Knowing your methodology, knowing your environment and knowing yourself.

MIKE McDERMOTT: In this business more than any other in the world, you get your report card on a day by day or month by month basis. And that report card is supposed to tell you something, to help you see whether you are in sync with the markets or not. So first of all, with every position you put on you should know the risk. As you have been saying repeatedly, risk control is the dominant factor in what makes a good trader.

And as Jack was saying, if your report card comes back and you aren't getting good grades, you have to adjust and adapt. It may mean that your methodology is out of sync with the markets right now. And there is nothing wrong with that, but you don't drive the plane into the ground while you're waiting for things to improve. You have to dial back and protect your capital, or else you put yourself out of business.

PETER BRANDT: Boy, that's a common theme with successful traders isn't it? It just comes up again and again. Risk management. Manage your risk.

Another question: In recent years there has been a proliferation of day trading in the stock and forex markets. Do you think that is more a function of technology, or does it more speak to the mentality of instant gratification for the generations in play?

JACK SPARROW: I would say it is a combination of both. For a certain mindset, day trading (or night trading for forex) is highly attractive because it offers a vision of not taking risk home, where you just go in and make money and get out. It sounds sexy to the beginner's ear, so people gravitate to it. For many I think day trading has become a waking dream, a modern day escape.

We are close friends with some highly successful day traders and have a deep respect for what they do. But I think it is an increasingly tough game, especially now, because the shorter your time frame the closer you get to fighting with supercomputers. If Goldman Sachs goes out and spends $20 million on a new row of SPARC supercomputers every quarter, trying to hone that millisecond edge even further, I don't want to be in the same niche with those guys.

So one of the reasons we love swing trading, and jockeying for multi-week or even multi-month positions, is that supercomputers can't play that game. There is no computer that can analyze the complexities of the global economy from a 10,000 foot view, sifting through the noise for that one area of opportunity where a trader can "get a hunch and bet a bunch." That remains the forte of the human trading mind.

I expressed the opinion a few years ago that computers are slowly taking over at the low time-frame end of the spectrum. First we saw computers replacing runners and floor clerks. Then we saw computers directly replacing floor traders, to the point where various exchanges went 100% electronic. And now with High Frequency Trading (HFT) they are gunning for daytraders and scalpers. And we just don't have a lot of personal enthusiasm for trying to compete in that particular niche of the market ecosystem.

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The other problem, especially in booming markets like forex and e-minis now, is that a lot of people aren't taking this stuff seriously. They are chasing a fantasy that hasn't been thought through. This is demonstrated by some of the crazy goals you hear, and wacky claims from systems sellers that don't make any sense. A classic one is, "I just want to make half a percent per day trading the mini S&P" – as if that were a modest goal. Okay then, where is your edge going to come from? What do you do that explains how you will achieve that? Lots of people wind up being cannon fodder.

MIKE McDERMOTT: Short-term trading has definitely had an impact. A lot of volume in markets these days is due to computers trying to grab a nano-tick here and there. But I appreciate that, because as swing traders, we have all the liquidity we need to move capital in and out of our positions. It's not a bad thing for us at all. The daytrading business is just a very challenging business.

PETER BRANDT: Are there any activities you enjoy outside of markets? Things that help you maintain perspective, ground yourself a little bit and create balance in your life?

MIKE McDERMOTT: I'll jump in first and say I've got a family. So whether I like it or not, when I go home I'm grounded by changing diapers, throwing the 11-year-old around and all that. So that's an involuntary grounding. But on the voluntary side, Jack and I both agree that physical exercise is a big part of getting re-centered and re-focused.

I'm a big runner… I enjoy getting on the treadmill, or being outside and putting some miles on the sneakers. Though I've also found that many times when I'm running, that is the best time for thinking about markets and developing new ideas. So sometimes running is centering and separating, but other times it is a point of clarity where your mind is free to think away from the screens. With your blood pumping and your endorphines kicking in, it becomes much easier to think outside the box.

JACK SPARROW: I'm a runner like Mike is – that is another area where we have fun competing. His legs are longer: I'm six-foot-one and he's six-foot-four. I like to joke that my brain is bigger, so it weighs me down a little bit.

Having Lake Tahoe as a backyard is just a paradise of outdoor activity – hiking, snowboarding, being outside and so forth. I also try to walk one of the nearby trails every day, weather permitting, which is another nice thing as we get 300 days of sunshine a year here. Traveling is a fun release, having the opportunity to visit cities and countries around the world… reading outside of markets can be another source of relaxation. I like delving into history, physics, biology and so on as a way of keeping things fresh.

And then there is poker, a game we both quite enjoy. Poker has many deep parallels with markets, and yet when I sit down to play poker, the outside world just completely melts away. I always know what I'm doing and have plenty of chips, so there is never any stress. It is highly absorbing and deeply relaxing at the same time.

I really agree with something Paul Tudor Jones said in the famous "Trader" documentary that he later bought up all the copies of. Essentially, PTJ said that trading properly can be so intense and so all-consuming, you have to have the ability to break away from it. You have to "shut things off" and embrace activities where you can let your mind recharge from time to time.

It is much like what you described with flying, and the way you saw flying as a blissful escape from markets. I think to do well in trading you need outlets like that – an ability to refresh yourself and just take a deep breath here and there. Because if trading is your life 24 hours a day, it is going to chew you up and burn you out.

And then finally, in the context of balance, part of the reason we started Mercenary Trader is because we love interacting with other traders. Just swapping stories and sharing camaraderie, the joy and the

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pain – sharing the love of the game. A sort of trader's fellowship, which helps remind you how great the game is and why you play it.

PETER BRANDT: There is a big gap between systematic trading and discretionary trading. If you look at where the money is being held on the managed futures side, it is not being held by discretionary traders. It is being held by systematic traders. What do you see as the good points of each, and why do you think the overwhelming amount of money in futures is managed by systematic traders?

JACK SPARROW: I would say for one, it really goes back to personality and what suits you best in markets. Jack Schwager, the author of the Market Wizards books, is an example. He talked about how, after interviewing all those top caliber discretionary traders, he wound up gravitating towards a mechanical approach because of his natural temperament. He liked the puzzle-solving aspects of building systems, but didn't like the up-close interaction with markets. So the systems worked better for him.

Systematic traders, or what I call mechanical traders, will often talk about the emotional advantage of distancing themselves from markets with computer-executed rules. Whereas the discretionary trader's response might be: "Wow, why would you want to be removed? Why would you give your money to a robot?"

One of the amusing criticisms of computer-based trading comes from the book *Paper Money* by Adam Smith, where his Wall Street mentor says in a Southern accent: "A good dawg is indispensible for hunting. Can't do without him. But you don't give the *gun* to the *dawg*!"

Regarding the prevalence of systematic trading in managed futures, a system can be advertised as reliable in a manner that is harder for a discretionary trader to match. A system is more stable from an institutional perspective because there is less risk of variation on the human side. A good system is not like a superstar manager who can suddenly walk out the door. A system can have excellent longevity, and the marketers selling the system can say reassuringly that "we have zero emotion in our trades" and so on.

And yet, I think discretionary traders will always have the chops to beat the pants off systematic traders in terms of long run performance. If you have a performance challenge over many years, I believe the top discretionary traders will almost always win. But that is because discretionary traders have more room in both directions. They can soar higher, but they can also screw up royally. They can crush the computer-based system when things are going well, but they can also underperform when they get ice cold. So another reason for systematic dominance in managed futures is an emphasis on steady, reliable returns over higher returns that might be less predictable.

PETER BRANDT: Is it possible to build leakage into a system that is hard to find? That is to say, can a system have performance problems that are hard to identify and root out?

JACK SPARROW: One of the real drawbacks of a mechanical system is what happens when you go through a period of drawdown. If you are a discretionary trader in a period of drawdown, the system is not just your rules, it is literally you. So you have more to analyze: You can look at your emotions and decision making patterns… you can do self-analysis along with your trades… whereas with a computer program, the ability to analyze is more removed. "Do I change this rule? Do I change that one?" Meanwhile the computer says nothing. It strikes me as tougher to respond to challenging periods when all you have is a sheet of rules.

And of course, we can't help but interpret these questions through a discretionary trading lens, because discretionary trading is what we do. I could never be a strict mechanical trader – I enjoy being involved in markets too much. I love the challenge of controlling and shaping my emotions, adjusting exposure levels to market conditions, fully engaging with markets as part of the process. So these one-step-removed guys, hey, that's great. It is just not the food we cook in our kitchen.

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PETER BRANDT: For me the real payoff in being a discretionary trader – where the music really plays as you put it – is in those one, two or three trades a year that you've diagnosed, that you've really figured out, and that you back up the truck for. That is where the fun is. And no systematic trader can have that fun.

JACK SPARROW: Absolutely. That goes back to the joys and challenges of the emotional process. Mechanical trading is promoted as positive because it "takes the emotion out." Well, that is a negative too, because taking the emotion out can leave you feeling cut off or disengaged.

What we would rather do is become intimately familiar with our emotions, so we can control them and train them and harness them. Well-managed emotion becomes an ally and a driver of high performance, rather than the enemy or something to be feared. This lets us participate in those incredible moments where all the stars align, while keeping our emotions fully reined in when need be. It is a philosophy of constructive embrace, moreso than cautious distance.

PETER BRANDT: There is that nuance of art that discretionary trading just adds to it.

JACK SPARROW: And when you have the right combination of positions on, and conviction is strong and things are unfolding beautifully, it can be like a symphony performance of Beethoven's Ninth, where it all just comes together gloriously. It is hard to find a better feeling.

PETER BRANDT: Guys, this has just been so much fun I can't tell you.

MIKE McDERMOTT: The pleasure was ours!

JACK SPARROW: We agree, it has been absolutely tremendous. We can't thank you enough for spending this time with us.

We hope you have thoroughly enjoyed this interview series — and judging from your feedback, a great many of you have. For those who want more of Peter, you can find him on twitter — @PeterLBrandt — and also at his new blog, http://PeterLBrandt.com.

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