



The Deep Stack Semi-Bluff Principle



Ready for a poker pop quiz? Here goes:

You are a tough, savvy Hold 'Em player in a high stakes no-limit game at the Wynn in Las Vegas. The blinds are \$10-\$25 and everyone is deep stacked, including you.

A few hours in, you find yourself up against a tricky opponent in the biggest hand of the night. The pot is huge — after the turn card hits, a big bet and call put \$40,000 in the middle.

You both wait for the river card... and a potential push all-in...

Now the quiz question: In terms of hole cards, one of you has pocket aces. The other has 3-5 suited. Given the above information, which holding would you prefer?

Sounds like a no-brainer right? A huge pot with an all-in confrontation coming? Pocket aces. Duh.

But of course, you know it's not that simple. And *because* it's not that simple, you know pocket aces is the wrong answer.

In the above scenario, you would definitely want to be the guy with 3-5 suited. But why?

Think about the information presented. It was clarified from the start that you are a "tough, savvy" player. That means you aren't prone to wasting chips or making dumb moves.

Now think about the "big bet and call" on the turn. We know perfectly well why a player with aces would stick around in that spot. He has aces!

But why would the 3-5 suited player still be in the pot? He wouldn't — unless the flop or turn gave him a concealed monster.

If the flop contained 2-4 and the turn was an ace, for example, the guy with aces would be ecstatic to have top set... and yet he'd be unknowingly *crushed* by the hidden straight (A-2-3-4-5).

The key deduction is that, no matter what, the player with 3-5 must have "drawn out" to a very strong holding — something much better than a single pair. Otherwise, he would neither have bet nor called on the turn.

And that is why, given the available information, you don't want aces in that spot. If you're up against a tough, savvy customer who hasn't gone away, they are probably no good!

The Cardinal Sin of Poker

Okay, so what does the above have to do with trading? Just this:

- Overplaying a 'big pair' (aces, kings) is a cardinal sin in poker.
- So called 'conservative' players overplay their big pairs constantly.
- Countless investors do the exact same thing.



- This is a gross failing of risk control...
- And savvy traders like to *take the other side* when it happens.

Those aces or kings sure look good preflop. And they might look just as good after the flop.

But really, aces and kings are nothing but a single pair — crushed by deuces if a lowly third deuce shows up. In fact, if your opponent improves (draws out) to *anything* better — two pair, a set, a straight or a flush etc. — then that beautiful big pair is an invitation to lose your stack.

In spite of this truth, players felt themselves (lose all their chips) with aces and kings on a regular basis. In poker parlance, this is known as “not letting go of the hand.”

You can probably see where this is going — **the same thing happens in markets.**

Oftentimes, when a trader or investor gets what he feels is an “aces or kings” situation — maybe based on the fundamentals, or his love of the company or some such thing — it later turns out he “can’t let go of the hand,” with a brutally outsized loss the result.

The Deep Stack Semi-Bluff Principle

“Now hold on,” the skeptical among you may be saying. “Go back to that quiz example for a second. Why would a skilled player ever come in with 3-5 suited in the first place? How is there ever justification to play that kind of rag hand?”

Playing a rag hand in poker is like taking a stand against the consensus. Most of the time you don’t do this — but sometimes it makes perfect sense.

The reason why has to do with deep stacks, pot odds, and highly attractive risk-versus-reward scenarios. To summarize:

- **Sometimes, a low cost speculation gives you a shot at getting your opponent’s *entire stack*.** If that stack is sufficiently large — or large enough to give favorable “payout odds,” or positive mathematical expectation on the play — then the speculation could be worth it.



The key thing is the “deep stack” part. There has to be enough payoff potential embedded in the situation to make your action worth while. Hall of fame poker player Dan Harrington has dubbed this principle “Harrington’s First Law:”

Harrington’s First Law: The gap in strength between strong hands and weak hands is inversely proportional to the stack sizes.

That’s true because the larger the stack sizes, the greater the payout expectation when a weak starting hand draws out to become a monster.

And here is Harrington in further detail:

...But when stacks are very big, the advantage of the aces shrinks dramatically. The reason? Only a small percentage of the stacks are going at it in the early rounds, when the aces are strong. If the five-three doesn’t hit the flop, no more money goes in. If the five-three hits the hand, huge amounts of money go in on the later streets, when the aces are at a big disadvantage.



So now we get to the paradox of no-limit hold 'em. The premium pairs are strong hands, but only in the sense that they win a high percentage of pots. The pots they win, however, tend to be small. The weird connecting cards, small pairs, and ace-suited hands lose most pots, but they have the potential of winning the very big pots.

That same paradox applies to trading and investing.

The “aces and kings” of the trading world equate to high likelihood conventional wisdom plays, where the prevailing consensus is mostly priced in.

Such orientation tends to work out a high percentage of the time, but with winnings that are small (or otherwise mediocre relative to the risk).

On the flip side, high-reward, out-of-consensus contrarian plays are like coming into a deep stack situation with 3-5 suited. Most of the time the result is a small loss. But when a concealed monster hits, the gains can be huge.

Understanding the Semi-Bluff

To further clarify terms, let's go over what a “semi-bluff” actually is.

- A pure bluff is an aggressive raise with nothing but chutzpah — an effort to win the pot with artifice or intimidation.
- A semi-bluff, on the other hand, is a bluff in conjunction with a favorable draw. When a player semi-bluffs, he can win in two ways — if everyone folds, or if he hits his draw on a future street.

The ideal semi-bluff is something like an open ended straight draw plus a flush draw on the flop. For instance: If I have Q-J of spades and the flop contains a 9, a 10, and two spades, then I have 15 ‘outs’ — 9 cards that complete a flush and 8 cards that complete a straight (with two of those overlapping).

Amusingly, a player with 15 outs to his draw actually has greater odds of winning (if the hand goes to showdown) than the guy with aces or kings! It's possible to have the best hand both before and after the flop, and still be the statistical underdog. (What a great game!)

Applying it to Trading

Now let's take the above food for thought and translate it to trading:

When a strongly dominant consensus view has developed, we can say the crowd is “pushing hard with a big pair (aces or kings).”

When the market becomes heavily extended (or exhausted) in the direction of the consensus, we can say the situation is “deep stacked” (in terms of the opportunity set).

Such situations thus offer a good opportunity to “semi-bluff” — i.e. to make a low risk contrarian speculation — if the right combination of “draws” and inflection points occur.

The QE2 Consensus — a Perfect Example

The overwhelming consensus surrounding “quantitative easing 2” is a perfect example of the Deep Stack Semi-bluff Principle at work. QE2 was the crowd's “big pair,” with firm and widespread belief that the Fed's actions would be inflationary and paper-asset stimulative.



What actually happened, as we now know, is that the bulk of QE2 expectations were priced in before the early November announcement — and furthermore, that the blastoff move in commodities immediately following QE2 turned out to be a giant headfake (at least in the near term).

This chain of events led to an ideal opportunity for a Semi-Bluff Reversal:

- **Semi-Bluff Reversal (SBR):** *A clear instance of chart pattern signal failure, catching the “aces and kings” consensus by surprise, after a likely climax in sentiment has occurred.*



The above chart of OIL, an ETN proxy for crude oil, tells the story (click the chart to enlarge). We actually went short copper, China and crude oil on the SBR day as indicated above, getting “beared up” as [documented here](#).

Our decision to “get a hunch and bet a bunch” was based on a confluence of factors. We had been skeptical of QE2 for some time (as ongoing commentary had expressed). We were also fully aware of bullish sentiment extremes and the potential impact of [gray swan developments](#) on the market.

Given all this, **the semi-bluff reversal pattern acted as an inflection point — a price-confirmed reason to pull the short trigger.**

Now let’s look at a bullish “Semi-Bluff Reversal” example, this one from earlier in the year.





As the Greek crisis intensified this spring, sentiment in the euro hit a bearish extreme. At the climax point, seemingly every investment bank and currency house in the world had a forecast for the euro going straight to par (\$1.00 USD).

Then, in early June as the chart shows, the euro's downtrend was definitively broken, calling further bearishness into question.

In later June, the euro broke down from a small rounded top pattern on the daily charts (note the circle). This breakdown was an invitation to go short for those who still considered the euro on its way to par. **When that breakout immediately failed, however, a semi-bluff reversal pattern occurred.**

The euro's subsequent surge higher turned out to be a good buy for reasons discussed in this piece: Stubborn bears, unable to "let go of their hand," wound up funding the ensuing rally!

As you can see, this stuff is not rocket science. Nor is it magic or mysticism, or some arcane application of technical voodoo to the charts. It is a logically grounded way of thinking and perceiving — an intersection of theory, strategy and practice.

The important thing here is to grasp the strategic principles:

- When sentiment flirts with extremes, watch for signs of climax!
- If you are holding aces or kings, be willing to "let the hand go."
- If the opportunity set is "deep stacked," watch for inflection points.
- If you get a "Semi-Bluff Reversal" opportunity, seize it!

Another truly beautiful thing about the Semi-Bluff Reversal, as you may have noticed, is the extremely favorable reward to risk ratio that such scenarios tend to offer.

This again goes back to the "deep stack" concept at work. **When sentiment reaches a powerful extreme, a lot of runway has been created for price to trend in the opposite direction** — sometimes for weeks or months at a time. And SBR inflection points are clear enough to couple tight stops with this vast potential.

(By the way: If you've ever wondered how legends like Stan Druckenmiller [booked decades of market-crushing returns](#), it was in part by aggressively exploiting optimal opportunity sets like these.)

Beware 'Fancy Play Syndrome'

Now that you see the merit of playing unconventional hands from time to time, it should be added: **One must be careful not to take it too far.** After all, there is *good reason* why 3-5 suited doesn't get played all that often!

Another useful term from the poker world is "Fancy Play Syndrome," or FPS for short. A player suffering from FPS is trying too hard to be deceptive... overdoing it with the "tricky" and "contrarian" plays. This can be a foolish and expensive habit.

It's a poker catch 22 — the timing of certain moves can only be learned with experience. Some plays are very powerful, but their proper distribution is very infrequent. You may come across them once in a blue moon. It thus becomes a challenge to both gather knowledge of these plays over time and respect their sparing usage profile.

For more on the need to avoid FPS — and to only make contrarian plays sparingly — we turn to the palindrome, George Soros:

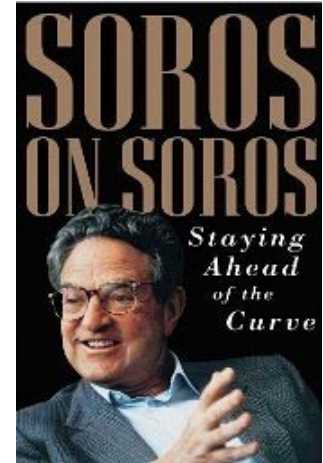


Being so critical, I am often considered a contrarian. But I am very cautious about going against the herd; I am liable to be trampled on...

Most of the time I am a trend follower, but all the time I am aware that I am a member of the herd and I am on the lookout for inflection points...

I watch out for telltale signs that a trend may be exhausted. Then I disengage from the herd and look for a different investment thesis. Or, if I think the trend has been carried to excess, I may probe going against it...

Most of the time we are punished if we go against the trend. Only at inflection points are we rewarded.



As we have said in the past, "Being contrarian at the wrong time is akin to arguing with a herd of cattle." There is not much value in it, unless you like getting trampled.

(This is why the Mercenary method never condones staying short in uptrends or staying long in persistent downtrends. Think of it this way: **A proper inflection point is supposed to 'inflect'**. If it doesn't do that in a reasonably tight space of time, you are wrong and may need to get out!)

One more piece of wisdom from Soros:

I am outside. I am a thinking participant and thinking means putting yourself outside the subject you think about. Perhaps it comes easier to me than to many others because I have a very abstract mind and I actually enjoy looking at things, including myself, from the outside.

To be a successful trader, **you must not be part of the herd**. You can RUN with the herd, certainly — that is the name of the game in the midst of trending markets — but you must always be watching, testing, mentally setting yourself apart.

It's the same in poker too: There are the vast majority of players on "auto pilot," and those who think "waiting for a good hand" is the sum requirement of good play... and then there are the 10% [who actually make all the money](#).

And finally: If you are enjoying these excursions into poker theory and practice as cross-applied to trading, here are some books to continue the journey:

- [Zen and the Art of Poker](#) by Larry Phillips
- [Harrington on Cash Games](#) by Dan Harrington
- [Elements of Poker](#) by Tommy Angelo
- [The Book of Bluffs](#) by Matt Lessinger
- [The Poker Face of Wall Street](#) by Aaron Brown

Fold Those Aces,

JS

p.s. Like this article? For more, [visit our Knowledge Center!](#)

p.p.s. If you haven't already, check out [the Mercenary Live Feed!](#)

