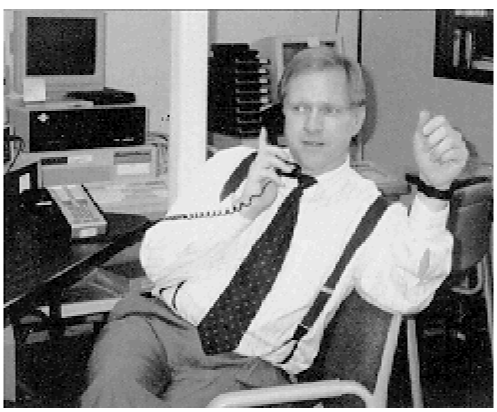
Ed Seykota Of Technical Tools

Ed Seykota, whose thoughts and insights were chronicled in Jack Schwager's book Market Wizards*, has been involved with trading commodities since the late 1960s. According to Market Wizards, Seykota's "model account" — an actual customer account — started with $5,000 in 1972 and to date has earned more than a 250,000% gain. Recently, in a new challenge, he purchased data and software vendor Technical Tools. S TOCKS & COMMODITIES Editor Thom Hartle interviewed Seykota in a series of written correspondence that took place over several months ending in May 1992, during which Hartle posed a number of questions relevant to all traders, including any secrets to trading successfully. Not too surprisingly, the answer to that was the same answer as for any endeavor — persistence and commitment!*

How did you get started in technical analysis? What was your first trade?

The first trade I remember, I was about five years old in Portland, OR. My father gave me a gold-colored medallion, a sales promotion trinket. I traded it to a neighbor kid for five magnifying lenses. I felt as though I had participated in a rite of passage. I started early to get interested in technical analysis, too. By the time I was nine, I had a bedroom filled with old radios, test equipment and oscilloscopes. I liked to generate and display wave forms . Later, when I was 13, my father showed me how to buy stocks. He explained that I should buy when the price broke out of the top of a box and to sell when it broke out of the bottom. And that's how I got started.



"The biggest secret about success is that there isn't any big secret about it, or if there is, then it's a secret from me, too. The idea of searching for some secret for trading success misses the point. " —Ed Seykota

With all that pointing you toward trading, was it inevitable that you would end up in it?

Actually, no. At the Massachusetts Institute of Technology (MIT), I studied servo theory, which is about self-controlling mechanisms such as thermostats, governors and chemical process controllers. Professor Jay Forrester showed me how to apply servo theory to economic modeling. His feedback dynamics approach required careful observation and deep thought about how things work.

Through the years I have gained tremendous insight, perspective, skills, inspiration and strength from books. A short list of some of my favorite books about the markets would have to include *Extraordinary Popular Delusions* by Charles McKay and *Reminiscences of a Stock Operator* by Edwin LeFevre.

So how did you get introduced to technical analysis?

About the time I graduated from MIT, I read an article by technician Richard Donchian that intrigued me. He demonstrated how a diversified simple five- and 20-day moving average crossover system made a respectable rate of return. That idea — the idea of an automatic mechanical moneymaking machine — fascinated me. So I bought some block time at a local computer service, spent my evenings punching up cards from *The Wall Street Journal* and began to reproduce Donchian's results. I tried varying the parameter sets and found that other combinations also worked. I noticed that longer-term smoothing worked pretty well, while transaction costs seemed to chop up shorter-term systems.

And then what did you do?

In the early 1970s, I went to work for a wire house. I would go in on weekends to use the IBM 360/65 accounting mainframe to run tests. I punched cards and ran batch jobs in FORTRAN 4. I managed to test four types of systems on about 50 different parameter sets on eight commodities going back a decade. It took me half a year. To show you how much computers have changed the way we do things, these days it might take one weekend on a PC.

So what did you do with that information?

Well, eventually, the management of the wire house packaged a product around my research. The problem was, my boss was unable to follow the system and *his* boss was more interested in souping up the system to generate more commissions. I told them their best move was to make money for their customers. No sale! Not only that, my boss reneged on his handshake that they would give me 10% of the commissions generated from the system. I got disgusted with them all and left.

So at age 23, I went out on my own with about a half-dozen accounts in the $10,000-25,000 range. A few years later, I checked back with the boys at the wire house. They had hundreds of sales agents raising money for their souped-up rewrite of my system. I had more money under management than they did, and mine came from internal growth of my original accounts. I felt exonerated and glad I had escaped from a system based so heavily on commissions.

And since then?

I still test systems and think about the markets. I still collect data. I still manage money.

What is the secret to your success? What do you consider to be good mental skills for successful trading?

The biggest secret about success is that there isn't any big secret about it, or if there is, then it's a secret from me, too. The idea of searching for some secret for trading success misses the point. It's like golf. Some golfers play to spend time outdoors. They hang out with their cronies, become one with nature, study the greens, reconnect with their muscles, drop into focused concentration and, incidentally, pick up a birdie or two. For others, it's an exercise in finding some new Holy Grail putter. Different strokes for different folks!

In that case, what can an individual do to become a successful trader?

The "doing" part of trading is simple. You just pick up the phone and place orders. The "being" part is a bit more subtle. It's like being an athlete. It's commitment arid mission. To the committed, a world of support appears. All manner of unforeseen assistance materializes to support and propel the committed to meet grand destiny.

Should a person focus his or her time on developing mechanical or non-mechanical (judgmental) methods?

Judgmental systems are inherently mechanical. Gut traders trade according to set rules of attitude, approach and personality. But I also feel that mechanical systems are inherently judgmental. System traders typically use judgment for the enormously important tasks of rolling forward, changing bet size and adding or deleting instruments.

The point is, no real conflict exists between judgment and mechanical trading. A conscious trader is aware of money management algorithms, trading systems and the need for supportive relationships. He maintains his knowledge of broad and local economic trends and remains aware of his feelings. He is also aware of how his own personality works and creates a workable ecology between himself and the world around him.

If you don't use a mechanical trading system, have you built a set of rules to trade by? What are they?

I have many rules and some higher laws. Some of the rules are: Trade with the long-term trend. Cut your losses. Let your profits ride. Bet as much as you can handle and no more.

What do you mean by "higher laws"?

I feel that higher laws and rules govern much of my trading. There is a higher law that commitment and service favor performance. There is a higher law that greed and selfishness impede it. I feel I am in tune with these laws when things just seem to click. Other times I feel out of sync, as if I'm pushing a dull mower through tall wet grass. Next to these higher laws, trading rules seem rather insignificant.

Are price moves random? Is there any basis for trends? What makes prices move?

I feel the "aha! " process lies at the heart of price change . For instance, consider the series: OTTFFSSE. What is the next letter? This puzzle creates tension — *until* you see the first letters of the ordinal numbers — one, two. "Aha!" you say. A lot happens during an "aha." The puzzle dies and the tension dissipates.

A societal "aha! " drives price. Read the newspapers and the news magazines during a major move. At first, no one gets why the move is happening. There's a lot of confusion. Part of the move's way up, some people get it. At the end, *everybody* gets it. The tension is resolved and the move ends.

Aha. I'll have to think about that. Can you tell us how you set stop-loss points?

Before I enter a trade, I set stops at a point at which the chart sours.

What about starting capital? How much money should a person have before starting to trade?

Good money management is equity invariant. I'd ask a trader who thinks he needs a certain amount before he can trade exactly what amount he would need to *stop* trading.

What are some of your favorite books that people should consider reading?

Through the years I have gained tremendous insight, perspective, skills, inspiration and strength from books. A short list of some of my favorite books about the markets would have to include *Extraordinary Popular Delusions* by Charles McKay; *Reminiscences of a Stock Operator* by Edwin LeFevre; and *The Crowd* by Gustare Le Bon.

Successful trading can be thought of as a business. Your new focus is running Technical Tools. Can you draw some comparisons between trading and running a business?

Yes. I find a lot of similarities between trading and business. In trading, I have learned to ride the long-term trend, cut losses and manage money. In the case of Technical Tools, our customers, suppliers, competition and trade publications such as STOCKS & COMMODITIES indicate the long-term trend and help point to where we should be heading as a company in this industry. When I hire someone, it is usually on a trial basis until a strong "trend" of productivity sets in. Cutting losses in business has to do with discontinuing unprofitable products. Firing, also like cutting losses, is tough on the emotions and vital to the eventual success of all involved. Managing money means spending less than we make as well as not betting the ranch on just one idea. I find that the principles of sound trading have close analogs in running a business.

"The 'doing' part of trading is simple. You just pick up the phone and place orders. The 'being ' part is a bit more subtle. It's like being an athlete. It's commitment and mission."

As Technical Tools develops I envision it as part of an enterprise in which trading and business converge. Lately, I have been beating the drum to call together a trading tribe, a kind of support group that borrows from tribal traditions as a means of cultivating group participation. Readers can write me in care of Technical Tools if they are interested in finding out more about this.

Running a business like a tribe sounds pretty unique. Thank you for your time, Ed.

You're welcome.

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McKay, Charles [1932]. *Extraordinary Popular Delusions and the Madness of Crowds*, L.C. Page, London.

Technical Tools, 334 State St., Los Altos, CA 94022, fax (415) 948-5697, BBS number (415) 949-1538.

DONCHIAN'S TRADING GUIDES

Richard D. Donchian, a well-respected Wall Street technician who began his career in 1930, initially compiled these guides in 1934 after suffering losses in 1929. He later dug them up again while working for Hayden Stone (now Shearson Lehman Brothers) and reviewed them in the firm's July 3, 1974, "Trend Timing" commodity letter. In that publication, Donchian noted which points he felt remained the most important: *General* 1,2,3,4 and 5 and *Technical* 1, 4,5 and 9.

Donchian's General Guides

1 Beware of acting immediately on widespread public opinion. Even if it is correct, it will usually delay the move.

2 From a period of dullness and inactivity, watch for and prepare to follow a move in the direction in which volume increases.

3 Limit losses and ride profits, irrespective of all other rules.

4 Light commitments are advisable when a market position is not certain. Clearly defined moves are signaled frequently enough to make life interesting, and concentration on these moves to the virtual exclusion of others will prevent unprofitable whipsawing.

5 Seldom take a position in the direction of an immediately preceding three-day move. Wait for a one-day reversal.

6 Judicious use of stop orders is a valuable aid to profitable trading. Stops may be used to protect profits, limit losses and take positions from certain formations such as triangular foci. Stop orders are apt to be more valuable and less treacherous if used in proper relation to the chart formation.

7 In a market in which upswings are likely to equal or exceed downswings, a heavier position should be taken for the upswings for percentage reasons; a decline from 50 to 25 will net only 50% profit, whereas an advance from 25 to 50 will net 100%.

8 In taking a position, price orders are allowable. In closing a position, use "market" orders.

9 Buy strong-acting, strong-background commodities and sell weak ones subject to all other rules.

10 Moves in which rails lead or participate strongly are usually worth following more than moves in which rails lag.

11 A study of the capitalization of a company, the degree of activity of an issue and whether the issue is a lethargic truck horse like Consolidated Edison or a spirited, volatile race horse like Case Threshing Machine is fully as important as a study of statistical reports.

Donchian's Technical Guides

1 A move followed by a sideways range often precedes another move of almost equal extent in the same direction of the original move. Generally, when the second move from the sideways range has run its course, a countermove approaching the sideways range may be expected (Figure 1).

2 Reversal or resistance to a move is likely to be encountered on reaching levels at which the

commodity has fluctuated for a considerable length of time within a narrow range in the past or on approaching previous highs or lows.

3 Watch for good buying or selling opportunities when trendlines are approached, especially on medium or dull volume. Be sure such a line has not been adhered to or hit too frequently.

4 Watch for "crawling along" or repeated bumping of minor or major trendlines and prepare to see such trendlines broken (Figure 2).

5 Breaking of minor trendlines counter to the major trend gives most other important position-taking signals. Positions can be taken or reversed on stops at such places (Figure 3).

6 Triangles of either slope may mean either accumulation or distribution depending on other considerations, although triangles are usually broken on the flat side.

7 Watch for volume climax, especially after a long move.

8 Don't count on gaps being closed unless you can distinguish among breakaway gaps, normal gaps and exhaustion gaps.

9 During a move, take or increase positions in the direction of the move at the market the morning following any one-day reversal, however slight the reversal may be, especially if volume declines on the reversal.

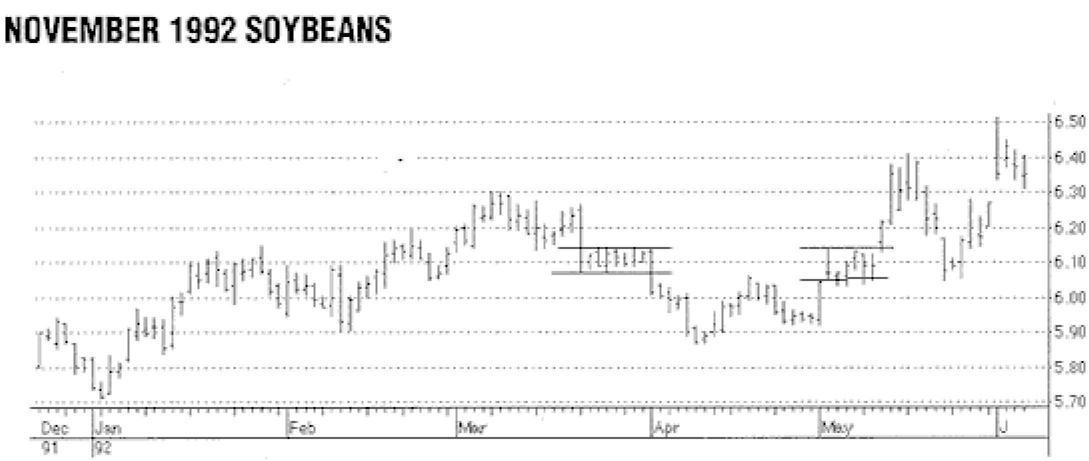

FIGURE 1: *Sideways price action may be followed by a resumption of the prior trend. Prices may travel about the same distance as before the sideways trading range and then move back toward the trading range.*

JUNE 1992 TREASURY BONDS

FIGURE 2: *Trendlines are typically broken where the market is repeatedly touching them.*

DECEMBER 1991 TREASURY BONDS

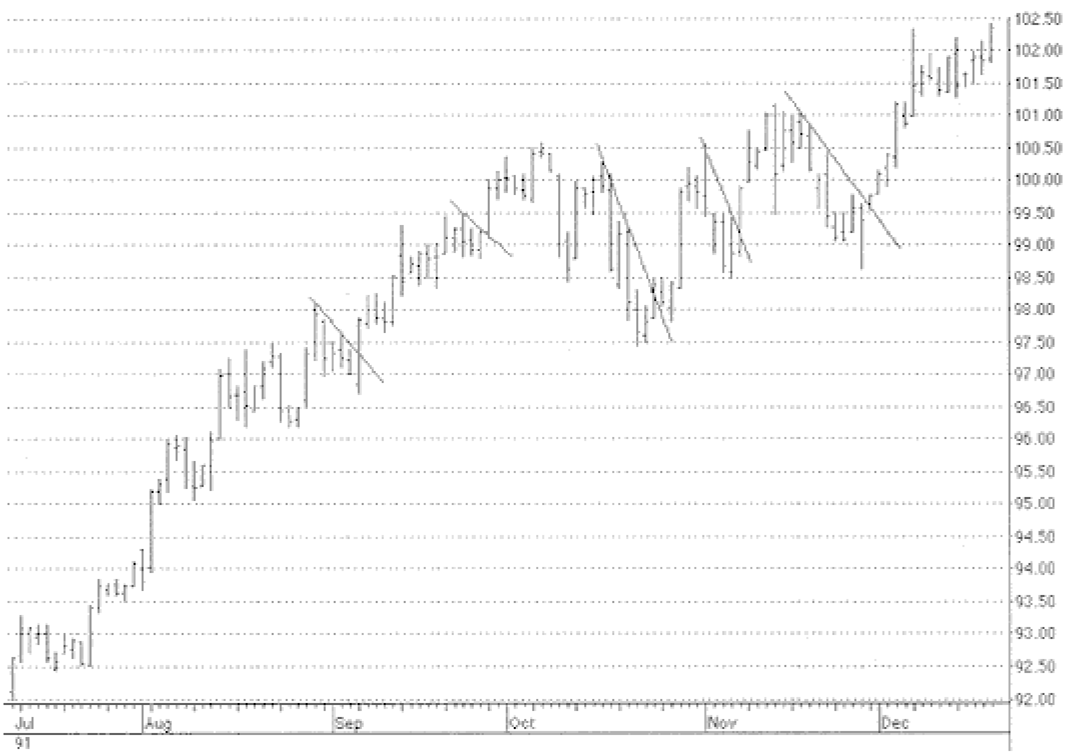

FIGURE 3: *Draw minor trendlines along minor trends that are counter to the major trend In this example, the major upward trend resumed when the minor downtrend lines were broken*.