The Traders' Psyche: Tom Basso

Why do traders trade? Is it for the potential profit? Is it for the love of the hunt? Or is it simply for the challenge? Jack Schwager, who interviewed Tom Basso, president of Trendstat, for his book The New Market Wizards, *dubbed the trader "Mr. Serenity " for his approach to trading, managing to be profitable while maintaining peace of mind. Basso, who has $65 million under management, has a trading philosophy that more individuals should embrace: simply, enjoy what you do. STOCKS & COMMODITIES Editor Thom Hartle interviewed Basso via telephone on August 16, 1993, on topics ranging from risk management to diversification and knowing your own trading style.*

In general, there are three key issues for traders — systems design, money management and trading psychology. Which one do you think new and old traders should focus on?

Investment psychology. If a trader doesn't have a good feeling about what he's doing as a trader, he won't successfully implement his game plan. If he's not completely comfortable with the trading system, then he'll run into pitfalls. That will stand in his way of being successful at trading.

Did you start out feeling comfortable with the trading systems that you were using?

Absolutely not! When I first started, I was trading a few contracts of corn and I ended up losing money on those trades. I had no money management, no risk control and almost no idea of what I was doing. It's been a long evolution for me, making mistakes along the way and paying what I refer to as the tuition of the college of trading. I've learned that building a set of risk and volatility controls and developing knowledge of the way I react to markets is the key. Traders have to feel comfortable with their approach.

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How does one go about developing a comfortable trading style beyond just back-testing a trading system?

Simple back-testing is defined as throwing a bunch of numbers in the computer and out comes the answer and you either like the answer or you don't. You may try testing again and again until you get the answer that you want. Back-testing can be useful, but I recommend you go one more step. Print out the

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gory details.

How much? Or how far?

If it's 10 years, print out 10 years. Sit there and wade through the day-by-day details. Plot each trade and make believe you are actually trading this market and let your thoughts go through your head uninhibited. This should give you a sense of what you'll be facing in the real world of trading. Be very honest with yourself. That's where you'll find some of the types of trades that will challenge you on a personal level. Otherwise, you may short-circuit applying that trading strategy without good knowledge of how you're going to react under stressful situations. That's when trading tends to fall apart.

What are some indications that a trader's going awry?

A trader will second-guess the signals or read a signal where it doesn't exist. There are so many different ways to go wrong.

I once read a recommendation that a person should take a trading system and set as his or her first goal just taking every signal to gain the ability to always take the signals How do you feel about that?

Plot each trade and make believe you are actually trading this market and let your thoughts go through your head uninhibited. This should give you a real sense of what you'll be facing in the real world of trading. Be very honest with yourself.

That's fine, but with real money in the markets that could get expensive. Again, one of the easiest things to do when you're in the fact-testing mode and you decide you like the results, before you jump into the real world of trading, is to test yourself. Go back over the price history and go through and live each trade day by day. Take your printout and place a piece of opaque paper over the top of it so you can't see what's coming next, and then move it down and see what happens. It might take you half a day, but it should be invaluable information on what's going to happen to your mind when you get into real trading.

There are two sides to trading, the losing side and the winning side. Drawdowns can create a lot of anxiety. Does the winning side also cause anxiety?

It does. Most people think that the losing side is the only problem. The fact is, winning can cause emotional problems, too. Sometimes people will get caught up in a profit-making mode and they'll get reckless. They'll start saying, "Well, I'm only playing with profits now." Traders can get into all sorts of emotional highs that are just as bad as emotional lows. Either emotional extreme tends to be dangerous.

How?

On the emotional high side, you get reckless and you don't put risk controls in the right place. Maybe you say to yourself, "I don't need stops now because the market is going my way so strong. I don't need to worry about it." If the trade starts going against you, you'll rationalize by saying, "I'm just giving away profits."

And the other side?

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On the other side, of course, is the low side where you're frustrated and you can't see the light of day. Everything's going down. How long will it take before I'm down to zero in my account? Either side is bad. You really need to stay balanced. Keep your head someplace in the middle and see some reward and some risk at all times, because no matter what the investment, there's always some reward and some risk.

The risk issue falls under money management. What are your guidelines for controlling risk?

This is a key issue for every trader, no matter what the trading strategy is. If you have control of yourself mentally, the next step is to make sure that you manage your money well.

Is that the voice of experience?

In the early stages of my career, I had no money management. I traded very few contracts and a small number of markets, so I wasn't diversified. I didn't have any money management other than putting a stop order in to avoid a disaster. I didn't diversify my portfolio and balance different positions against other positions — all these things we do today.

So money management and trading strategies are quite different.

A trading strategy answers the question of what and where do we want to buy or sell. It does not say how many do we want to buy, how many do we want to sell.

So it's a matter of specifics?

Most traders tend to look at one contract in one specific market and develop a trading strategy. You might even look at several different markets, but it's one market at a time, one contract at a time. In the real world of trading you find yourself in situations where you want to trade one Standard & Poor's contract and you also want Eurodollar futures in your portfolios. You might need to do 20 Eurodollars to have the same effect of one S&P contract because of the differences between those contracts or the volatility in the way those two markets move.

So portfolio management comes into play in trying to set your exposure to each of those markets in a logical fashion. Most new traders tend to totally ignore this area, and it is so important.

How about a simple example of portfolio management?

If you want to try an experiment, take four or five markets and try trading one contract each with your strategy. Run the numbers and see what your results are and do it over a certain period of time. Then go back and use a simple rule of thumb like the average movement of each of these markets over the last 10 days and define your risk exposure to 1% of your equity in each day of each of these markets (see sidebar, "Simple risk control"). Use the same markets, same buy and sell signals — but alter the number of contracts to be adjusted to whatever your equity does. You'll get different answers in the end of your simulation that'll be very interesting and you'll immediately become a fan of doing more in money management.

You did an experiment with a group of people on money management. Can you tell us about that?

A couple of years ago, I was asked to speak at a professional traders' school run by Dr. Van Tharp in Raleigh, NC. There were 14 professional traders who were going to be full-time money managers and they were attending a two week boot camp. I was speaking on the importance of risk control. I gave them an exercise that required the traders to set their risk exposure but through a random number generator I fed back the buys and sells that generated profits to losses at a two-to-one ratio.

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What were the rules of the game?

Each trader had $1,000 and was required to make 20 trades, risking a minimum of $1 to a maximum of the total available equity per trade. I wanted to simulate real world pressures, so each trader had a minimum target of 10% return over the 20 trades. Any trader whose losses exceeded 30% was considered fired. I stopped the trading session after 15 trades to avoid someone from going for broke on the last few trades. We measured success by dividing the overall return by the worst loss or drawdown.

How did they do?

Nobody really did too badly (Figure 1). No one made a killing either. The traders controlled their risk and in general met the objective set out at the start of the exercise. Then about 12 month later, I was asked to speak at an American Association of Individual Investors computer users' group in St. Louis.

Did you give them the same exercise?

Yes. I had about 22 people in the audience. I thought this would be a perfect way to see how a group of average amateur traders would do at the same exercise. I used the same exact random-number generated buy and sell signals, the same exact handouts, the same criteria. I found what you might expect.

Such as?

A wider variance (Figure 2). We had a number of people who were fired by their theoretical clients and we had a number of people who made huge sums of money because they bet the farm on one trade. You'd expect the return by amateur traders, of new traders especially, to be wider, and this group confirmed that. It was very interesting to see the differences between the way the professional trader approaches trading and controlling risk through money management and the way the amateur approaches trading.

How so?

The amateur worries about guessing whether they're getting a buy or sell signal or a buy in an up or down move in the market rather than worrying about how much risk to expose themselves to due to market movement.

Sounds insightful.

It was. Just for comparison's sake, Iran cases on my computer with the same winloss ratio as the exercise. The optimum strategy for a 10% minimum return was to invest 2% of equity on each trade (Figure 3). Over 15 trades this generated a 5.9% return and a reward-to-risk ratio of 1.49. Over 20 trades this approach generated a 12% return.

Well, in the real world, portfolio management and diversification do depend on something within the portfolio having a good trend — the home run trade, so to speak. How do you identify a potential home run trade?

I look for a market that isn't trending right now. That can be done a number of ways. Probably the most popular technical indicator for that is the average directional index, but there are a number of indicators available that can do this. I look for an indication that a trend either exists or doesn't. I like to look for those markets that aren't currently trending, the ones that nobody cares about. Those are the markets that are likely to make a move one way or another.

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Trader #	Return %	Maximum drawdown	Reward to risk
1	30.50	19.09	1.60
2	15.00	6.82	2.20
3	5.70	4.37	1.30
4	5.50	3.33	1.65
5	1.50	7.14	0.21
6	7.10	5.06	1.40
7	13.40	9.52	1.41
8	13.40	9.81	1.37
9	5.70	3.99	1.43
10	33.00	15.89	2.08
11	7.50	4.88	1.54
12	–9.10	25.07	0.00
13	15.90	10.97	1.45
14	25.90	19.00	1.36
Best	33.00	3.33	2.20
Worst	-9.10	25.07	0.00
Avg.	12.21	10.35	1.36
Invest 2% of equity	5.9	3.96	1.49

FIGURE 1: PROFESSIONAL TRADERS SCHOOL, 5/92. *The professional traders had an average return of 12.21% compared with a fixed 2% risk for a return of 5.9%. Nine of the 14 traders beat the fixed 2% risk approach, but only five had a lower reward to-risk ratio*

Trader #	Return %	Maximum drawdown	Reward to risk	
1	15.00	9.52	1.58	
2	–30.00	30.00	0.00	Fired
3	40.00	13.60	2.94	
4	19.25	23.80	0.81	
5	20.20	16.60	1.22	
6	75.00	37.50	2.00	
7	488.00	20.33	24.00	
8	350.00	33.00	10.61	
9	–35.00	35.00	0.00	Fired
10	26.00	18.00	1.44	
11	–75.00	75.00	0.00	Fired
12	15.00	31.80	0.47	
13	–30.00	30.00	1.45	Fired
14	–31.00	31.00	0.00	Fired
15	–30.00	30.00	0.00	Fired
16	–40.00	40.00	0.00	Fired
17	–30.00	30.00	0.00	Fired
18	–30.00	30.00	0.00	Fired
19	60.00	16.70	3.59	
Best	488.00	9.52	24.00	
Worst	–75.00	75.00	0.00	
Avg.	60.53	28.94	3.22	
Fired				9
Invest 2% of equity	5.9	3.96	1.49	

FIGURE 2: AAII COMPUTER USERS GROUP, 10/92. *The nonprofessional traders had a wide range of returns and nine traders were fired in the trading scenario.*

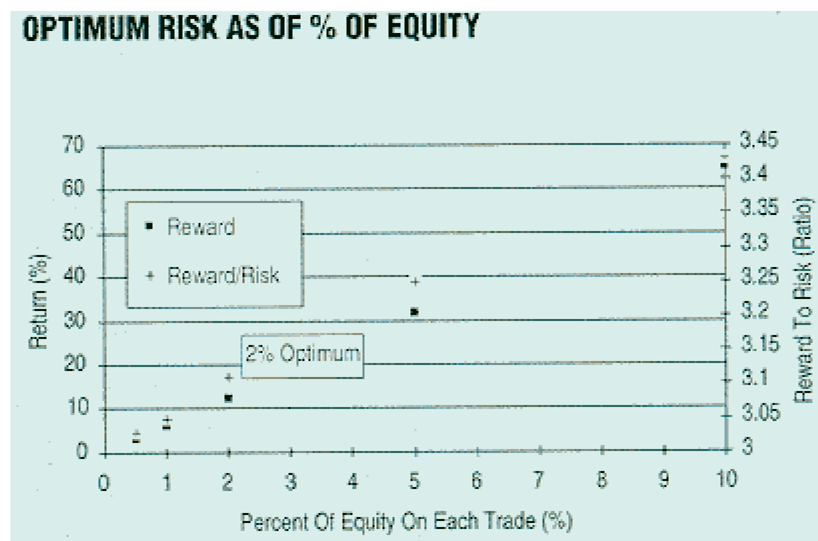

FIGURE 3: *Over 15 trades, this generated a 5.9% return and a reward-to-risk ratio of 1.49. Over 20 trades, this approach generated a 12% return.*

And when you find them?

The type of trading that we do is to look for some, kind of a breakout and get on board that trend and hope it is the start of a new big winner.

What if it's not?

If it isn't and it turns against me, I go ahead and take the small loss or maybe make a small profit and then move on to the next trade. The opposite is also true if we are in a market that is extremely trending, when things are just getting crazy and everyone is talking about this market. That's the time where we are making a lot of money, no doubt because we are trend followers. We should have a position in that market and be in the direction of that long-term trend, and I'll milk that market for all it's worth. However, when stops are hit, I'd call it quits, book the profits and let the market calm down before I get interested in it again.

Your money management strategy probably has you scaling out of winning positions, doesn't it?

Yes, it does. In the old days — going back to 1987 — I remember a silver trade. We got in at $5 and we rode that market all over the place. We made a handsome profit, but the ride was exhausting from making money one day and losing the next. That taught me a good lesson on trying to control how exposed my accounts are to the changing volatility in markets.

What do you do differently today from then?

Today, I adjust my exposure for market conditions, which are always changing. If the market is getting more exciting and I have too many contracts, I might have five on and I should only have three, so I sell two of them off. You have to manage your account in markets where you're getting a lot of movement in your direction.

How does that affect you emotionally?

This will start to cause more emotional pressure because you're making too much money, or you ' re losing too much and it's starting to get to you as a trader. Just back off to your own comfort level. There's a point where everyone should be, where their equity is exposed to just enough risk so that they are going to make reasonable profits — hopefully significant profits — but not push the envelope.

How do you know where that is?

For each trader this is different. You have to set your own risk and know your own volatility tolerance levels. This idea gets back to personal psychology. You have to know your levels, where your envelope is. Once you know that, it becomes pretty easy.

To get a sense of what a trader may be in for, you would need to test portfolio strategies. Did you develop your own software for portfolio management or buy something off the shelf ?

You can develop portfolio management with programs like DBASE and FoxPro. You have to know how to program, but programming isn't that difficult. Start with a simple example like a five- and 10-day moving average and create a simple trading system, a system that you can literally do on a calculator. Everything else is variation that just gets more complicated on that same theme. Little by little you can get more and more sophisticated regarding money management and volatility controls. That's how we developed our

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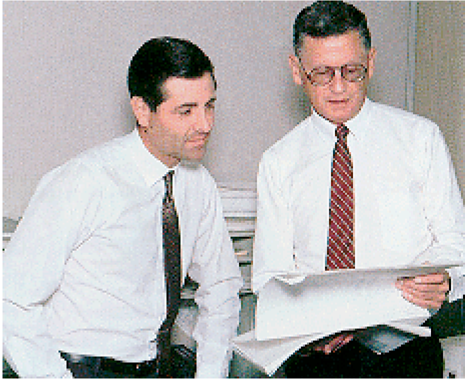
own programs.

I would imagine developing your own programs helped your comfort level, because you really knew what was going on for both trading signals and portfolio management.



Most people think that losing is the only problem Winning can cause emotional problems, too. (Basso, left; Lou Lewis, director of information systems, right.)

Off-the-shelf products, where you buy a black box and you have no idea what is generating the trading signals, are insidiously poor for your psychological side. This is probably why traders have such a difficult time of being successful when they use systems developed by others.

We're back to trading psychology.

Right. This doesn't necessarily mean that the trading system being sold is by itself bad. More likely, the person implementing it will begin to override or change the system. Maybe the trader will try to use it with another method that it wasn't meant to be used with. If the trader doesn't feel comfortable with the system, then in the end, he will discard it. Typically, you go through a tough period and start questioning the system. All types of psychological questions seem to come into play a lot more if you buy an off-the-shelf system than it would be if you designed your own.

But?

But the problem with designing your own is the off-the-shelf design software is still limiting in today's technology, because the focus is designing a trading strategy for one market. It's easier to go ahead and learn something like FoxPro or DBASE and just play around with programming for a few days. You'd be amazed at how much you can learn how to program.

What about ideas for the basis of your programmed trading strategies? How have they come to you?

The first thing that I did was look through magazines like *Technical Analysis of* STOCKS & COMMODITIES. I tried to stimulate my mind to develop ways that as a trader I would feel comfortable trading. Again, you need to know what your personal style is. For me, I'm a long-term type of guy. I've always wanted to spend minimum time looking at the trading and the markets and maximum time thinking about strategy and developing new systems.

You're more comfortable watching the horizon.

Right. So if I see an article on day trading in your magazine, I'll probably browse through it really quickly, but if I see an article about long-term trading, I'll find that more seductive and read more

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thoroughly. That's why knowing yourself is the critical function of trying to develop your own trading strategy. What kind of skills do you have? Are you a computer programmer or do you want to start learning computer programming? Do you really want to trade without a computer? A lot of people do.

So what did you end up with?

My background is engineering. I know programming and I ended up with something that, first of all, is a very automated operation. I'm a long-term strategist, so I'm a long-term position trader. Again, that fits me. I monitor my risk and equity volatility levels closely and keep them a lot lower than a lot of other traders probably do. I want to avoid fairly severe drawdowns.

Recognizing your own trading skills and limitations help a lot in that.

Knowing who you are as a trader and what your skills and basic resources are should go into the design of your trading system. If you mismatch what you're trying to do to who you are and what skills and resources you have, you're always going to be fighting it and never be in sync with it. If, on the other hand, you match your trading system to yourself, then trading can become as easy as breathing.

So it's critical to monitor yourself, your trading strategies as well as the markets?

Correct. I recommend that you keep a trading log. You can monitor how well you are implementing your strategy and your emotional reactions to the way you are trading. You should have down in print what you did and why you did it and how you felt about it. Then, if you are suffering from a lot of emotional ups and downs, you can refer back to your trading journal and figure out what it is you're doing and alter your strategy to bring the stress back down to a more comfortable level.

How many markets do you follow today?

Trendstat manages two different types of stock portfolios, which are growth and high income. We trade in about 25 different no-load mutual funds, we trade in 21 futures or commodity-related markets and we trade in 12 24-hour cash currency markets.

Do you apply the same format to each market?

Not precisely. There are different wrinkles to all the different markets we deal with. For example, in futures, your leverage and execution costs are low compared with stocks, where execution costs are much higher. In stocks you would need to have a more long-term approach to keep activity low. You can't go short mutual funds, so you have to eliminate short-selling as a part of the model. There are different wrinkles like that, where each program has to be specifically tailored to the way that market operates.

We address each market as we see it operating . We've built a decision-making model that fits the way we do things, and once we have it all fine-tuned, we let the computers do the work.

Do you look at markets individually or do you incorporate intermarket analysis? For example, if interest rates are doing one thing, does that affect a model for the stock market?

That's a good question. What works for me is the closer I get my trading strategy to what's making me money or losing me money, the more in step I tend to be in that particular market. Over time this will make it easier on me as a human being to be a good trader.

For example?

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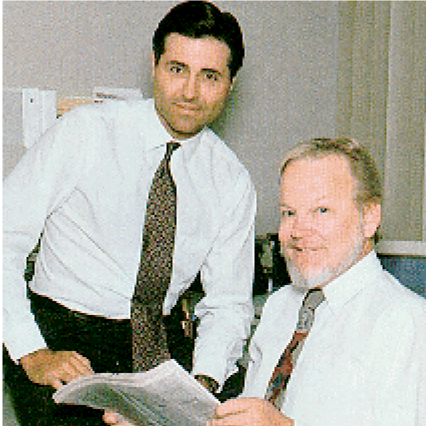
Well, an investor may conclude that the economy is strong, and so therefore I am going to buy IBM stock. If we do so, we are making the presumption that the economy being strong is going to take the price of IBM stock up. In fact, what tends to happen from my viewpoint is that IBM will go up or down based on various investors, institutions and individuals coming in and buying or selling IBM stock. We know that the more supply there is of IBM versus demand, the more prices will fall, or if the demand is greater than the supply, the more prices will firm.



Good traders know exactly what they're going to do when they come to work everyday. They know exactly what their risk exposures are and they know how they are going to react Finally, keep your ego out of trading. Unless you're humble in the fare of the markets, the markets will see to it that you are humbled. (Basso, left; George Tingom, managing director, right)

So this is another case of reality not coinciding with theory?

In reality, each one of those individual traders making the decision to buy or sell IBM think they're right. The closer I've been able to get my trading strategies oriented toward tracking IBM and ignoring other things that aren't directly related to me making or losing money in IBM, the more I've been able to get reproducible results.

It really* is *a case of trader, know thyself

Sure. I want to understand very clearly why I am losing or making money this month. The reason I make or lose money is that prices move up and down versus my positions. That knowledge has made my life a lot simpler in terms of trading strategies development. I have tended to look less at nonrelated items over the years after I've realized that.

Do you include volume or open interest in your analysis on the futures markets?

I've never been able to develop any indicator based on volume and open interest that created reproducible results. My theory is when there's volume, there is a buyer and a seller. When there is open interest, that means somebody just kept a contract on.

Would that be bullish or bearish?

I'm not sure how much that speaks to whether it's a bullish or bearish indication of the market. If a buyer and seller both execute a trade, they both think they are right or maybe they have different reasons for executing the trade. I don't view it as bullish and bearish, it's just a trade. I haven't been able to come up with an indicator that adds an edge to the way I trade when simulated over a lot of markets or a lot of

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different periods. I'm not saying there isn't room for research; but I haven't been able to automate something that I can statistically produce an edge for myself.

We're just about out of time. Do you have any concluding comments?

I think good trading is a combination of the three elements you brought up at the beginning. It is knowledge of yourself, knowledge of money management and exposing yourself to the right risk level, picking different markets that are unrelated so you can be diversified. You need to develop a sound strategic decision making process that you can follow that takes care of certain scenarios that you're going to run into. You don't want to wake up every morning and say, "I wonder how I am going to trade today? I have no idea what I am going to do! I don't know what my risk is." It would be a nightmare to trade that way.

Good traders know *exactly* what they're going to do when they come to work everyday. They know *exactly* what their risk exposures are and they know how they are going to react. Finally, keep your ego out of trading. Unless you're humble in the face of the markets, the markets will see to it that you are humbled.

Thanks for your time, Tom.

You're welcome, Thom.

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