Market Brief – Thinking About Thinking

"The Secret to my success is that I'm always wrong. I'm ALWAYS wrong. And I try to correct my mistakes. That's the secret of my success." - George Soros

I watched this youtube video over the weekend of George Soros (one of the greatest macro minds ever) being interviewed at Google by Eric Schmidt.

They covered a number of topics ranging from terrorism, to what makes for good government, and also Soros' push for open societies — I was hoping for more talk on credit-liquidity and position sizing, but I guess I'm unusual in that respect.

At one point one of the Googlers asked Soros — rather naively — what his "secret sauce" is for his extraordinary trading success. Without hesitation, Soros said the line above. The people in the audience laughed, thinking the answer glib and that the Palindrome was keeping his cards close.

But Soros wasn't joking, nor playing coy. He was being dead serious. He just revealed in a few words, the "secret" to successful trading.

I've spent years deconstructing the greatest traders and investors and their processes in search of commonalities. And the single trait that each and every one of them possess is a total devotion to truth. This results in not just a willingness to *accept* when they're wrong… but a fervent devotion to trying to find out *when* and *how* they're wrong — they don't get offended when proven wrong, they absolutely relish it!

This is extremely important in trading because you'll be wrong far more than you'll be right. This simple fact is too hard for most to tackle. And it's one of the reasons why markets have such a high turnover rate of players.

Just think of all the things you have to get right in order to be *really* right when you put on a trade.

- Direction
- Entry and stop placement
- Timing
- Potential return
- Drivers

It's not easy. You can be right on the macro direction, but wrong on the shorter time frame. This will screw up your entry and stop placement and result in you getting knocked out of your position. And all before a monster move that confirms your call (painful).

You can be right on direction, timing, and entry, but misjudge the length/sustainability of the move. This will result in a failure to take profits at the right time, only to have the trade round-trip on your ass and hit your original stop (this is even more painful).

You can nail nearly everything. You can get the direction, timing, entry and runway, and make a very profitable trade. But… your original thesis about the drivers behind the trade could end up being *completely* wrong (these trades are more bearable).

So yep, it's hard. It's *very* hard to be right as a speculator.

But the great thing about being traders is that unlike politicians, we can be waffling mo-fos. We want to be the ultimate wafflers. We want to always question our judgement and our opinions, while being quick to evolve our thinking through Bayesian analysis when new information comes our way.

We have to accept that we're incapable of being perfectly objective and that our brain will subconsciously color our thinking with a host of unhelpful biases and heuristics.

Tyler, Anish and I have been talking a lot about this lately. We see very smart and knowledgeable macro thinkers/traders like Raoul Pal for example, who've been wrong about the markets for... such… a long… time.

And it's not just that he's been wrong, but it's how *long* he's been wrong for. He's been calling for a massive banking crisis since 2012 and has been using the same argument with the same level of conviction for the last four years.

Now I'm not trying to pick on Raoul, I like a lot of his work. But I just can't help but ask, why hasn't he done some self-reflection to see if he's missing some key pieces? Or maybe review whether he needs some new mental-models in his tool kit? Obviously what he's been using isn't getting the job done this time.

The mentality we're talking about here doesn't mean we should profess total ignorance and flip-flop on our market calls after every little price fluctuation… far from it.

It means we need to tirelessly work towards the unattainable goal of perfectly balancing fluidity of opinion and conviction in relation to the mental-models that we employ to evaluate the markets.

It's all about finding the sweet spot, the cross-section where the need for informed conviction and fallibility meet. I call this sweet spot "Druck Town" because I don't know of any other trader who embodies this more than the sultan of swat, Stanley Druckenmiller (who was mentored by Soros).

Experience, reflection/reassessment, and more experience is the road that takes us to Druck Town. And a host of mental models is our transportation for getting there. Here's Munger on the subject:

> "Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form.
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> You've got to have models in your head. And you've got to array your experience both vicarious and direct on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and in life. You've got to hang experience on a latticework of models in your head.
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> What are the models? Well, the first rule is that you've got to have multiple models because if you just have one or two that you're using, the nature of human psychology is such that you'll torture reality so that it fits your models, or at least you'll think it does…
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> It's like the old saying, "To the man with only a hammer, every problem looks like a nail." And of course, that's the way the chiropractor goes about practicing medicine. But that's a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So you've got to have multiple models.
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> And the models have to come from multiple disciplines because all the wisdom of the world is not to be found in one little academic department. That's why poetry professors, by and large, are so unwise in a worldly sense. They don't have enough models in their heads. So you've got to have models across a fair array of disciplines.
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> You may say, "My God, this is already getting way too tough." But, fortunately, it isn't that tough because 80 or 90 important models will carry about 90% of the freight in making you a worldly wise person. And, of those, only a mere handful really carry very heavy freight."

To Raoul, I would say that he could benefit from a mental-model on how credit-liquidity cycles generally play out. If he had this mental-model, he would've been very bullish in 2012 for the coming years.

To Alex (me) of earlier of this year, I would say that I could have benefited from utilizing my "markets tend to mean-revert" mental-model. I also should have remained more open to new information that indicated liquidity was temporarily easing due to dovish Fed and China QE. Instead, I remained too inflexible in my thinking and was blinded to some great opportunities (ones that were obvious in hindsight). I was wrong and was slower than I like in getting right.

I'm currently halfway through Tetlock and Gardner's book, *Superforecasting: The Art and Science of Prediction.* It's an excellent and fascinating read into the obstacles we face in making predictions and the steps we can take to improve our success.

The authors conducted a number of studies (many involving our top Intelligence agencies) and came up with the following "Ten Commandments" for effective decision/prediction making. Here's the list with commentary by Farnam Street Blog:

1. Triage

> Focus on questions where your hard work is likely to pay off. Don't waste time either on easy "clock-like" questions (where simple rules of thumb can get you close to the right answer) or on impenetrable "cloud-like" questions (where even fancy statistical models can't beat the dart-throwing chimp). Concentrate on questions in the Goldilocks zone of difficulty, where effort pays off the most.

For instance, don't ask, "Who will win the world series in 2050?" That's impossible to forecast and unknowable. The question becomes more interesting when we come closer to home. Asking in April who will win the World Series for the upcoming season and how much justifiable confidence we can have in that answer is a different proposition. While we have low confidence in who will win, we can have a lot more than trying to predict the 2050 winner. At the worst we can narrow the range of outcomes. This allows us to move back on the continuum from uncertainty to risk.

> Certain classes of outcomes have well-deserved reputations for being radically unpredictable (e.g., oil prices, currency markets). But we usually don't discover how unpredictable outcomes are until we have spun our wheels for a while trying to gain analytical traction. Bear in mind the two basic errors it is possible to make here. We could fail to try to predict the potentially predictable or we could waste our time trying to predict the unpredictable. Which error would be worse in the situation you face?

2. Break seemingly intractable problems into tractable sub-problems.

This is Fermi-style thinking. Enrico Fermi designed the first atomic reactor. When he wasn't doing that he loved to tackle challenging questions such as "How many piano tuners are in Chicago?" At first glance this seems very difficult. Fermi started by decomposing the problem into smaller parts and putting them into the buckets of knowable and unknowable. By working at a problem this way you expose what you don't know or, as Tetlock and Gardner put it, you "flush ignorance into the open." It's better to air your assumptions and discover your errors quickly than to hide behind jargon and fog. Superforecasters are excellent at Fermi-izing — even when it comes to seemingly unquantifiable things like love.

> The surprise is how often remarkably good probability estimates arise from a remarkably crude series of assumptions and guesstimates.

3. Strike the right balance between inside and outside views.

Echoing Michael Mauboussin, who cautioned that we should pay attention to what's the same, Tetlock and Gardner add a historical perspective:

> Superforecasters know that there is nothing new under the sun. Nothing is 100% "unique." Language purists be damned: uniqueness is a matter of degree. So superforecasters conduct creative searches for comparison classes even for seemingly unique events, such as the outcome of a hunt for a high-profile terrorist (Joseph Kony) or the standoff between a new socialist government in Athens and Greece's creditors. Superforecasters are in the habit of posing the outside-view question: How often do things of this sort happen in situations of this sort?

The planning fallacy is a derivative of this.

4. Strike the right balance between under- and overreacting to evidence.

> Belief updating is to good forecasting as brushing and flossing are to good dental hygiene. It can be boring, occasionally uncomfortable, but it pays off in the long term. That said, don't suppose that belief updating is always easy because it sometimes is. Skillful updating requires teasing subtle signals from noisy news flows— all the while resisting the lure of wishful thinking.
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> Savvy forecasters learn to ferret out telltale clues before the rest of us. They snoop for nonobvious lead indicators, about what would have to happen before X could, where X might be anything from an expansion of Arctic sea ice to a nuclear war in the Korean peninsula. Note the fine line here between picking up subtle clues before everyone else and getting suckered by misleading clues.

The key here is a rational Bayesian updating of your beliefs. This is the same ethos behind Charlie Munger's thoughts on killing your best loved ideas. The world doesn't work the way we want it to but it does signal to us when things change. If we pay attention and adapt we let the world do most of the work for us.

5. Look for the clashing causal forces at work in each problem.

> For every good policy argument, there is typically a counterargument that is at least worth acknowledging. For instance, if you are a devout dove who believes that threatening military action never brings peace, be open to the possibility that you might be wrong about Iran. And the same advice applies if you are a devout hawk who believes that soft "appeasement" policies never pay off. Each side should list, in advance, the signs that would nudge them toward the other.
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> …
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> There are no paint-by-number rules here. Synthesis is an art that requires reconciling irreducibly subjective judgments. If you do it well, engaging in this process of

> synthesizing should transform you from a cookie-cutter dove or hawk into an odd hybrid creature, a dove-hawk, with a nuanced view of when tougher or softer policies are likelier to work.

If you really want to have fun at meetings (and simultaneously decrease your popularity with your bosses) start asking what would cause them to change their mind. Never forget that having an opinion is hard work. You really need to concentrate and rag on the problem.

6. Strive to distinguish as many degrees of doubt as the problem permits but no more.

This could easily be called nuance matters. The more degrees of uncertainty you can distinguish the better.

> As in poker, you have an advantage if you are better than your competitors at separating 60/ 40 bets from 40/ 60— or 55/ 45 from 45/ 55. Translating vague-verbiage hunches into numeric probabilities feels unnatural at first but it can be done. It just requires patience and practice.

7. Strike the right balance between under- and overconfidence, between prudence and decisiveness.

> Superforecasters understand the risks both of rushing to judgment and of dawdling too long near "maybe." They routinely manage the trade-off between the need to take decisive stands (who wants to listen to a waffler?) and the need to qualify their stands (who wants to listen to a blowhard?). They realize that long-term accuracy requires getting good scores on both calibration and resolution— which requires moving beyond blame-game ping-pong. It is not enough just to avoid the most recent mistake. They have to find creative ways to tamp down both types of forecasting errors— misses and false alarms— to the degree a fickle world permits such uncontroversial improvements in accuracy.

8. Look for the errors behind your mistakes but beware of rearview-mirror hindsight biases.

It's easy to justify or rationalize your failure. Don't. Own it and keep score with a decision journal. You want to learn where you went wrong and determine ways to get better. And don't just look at failures. Evaluate successes as well so you can determine when you were just plain lucky.

9. Bring out the best in others and let others bring out the best in you.

> Master the fine art of team management, especially perspective taking (understanding the arguments of the other side so well that you can reproduce them to the other's satisfaction), precision questioning (helping others to clarify their arguments so they are not misunderstood), and constructive confrontation (learning to disagree without being disagreeable). Wise leaders know how fine the line can be between a helpful suggestion and micro-managerial meddling or between a rigid group and a decisive one or between a scatterbrained group and an open-minded one.

10. Master the error-balancing bicycle.

> Implementing each commandment requires balancing opposing errors. Just as you can't learn to ride a bicycle by reading a physics textbook, you can't become a superforecaster by reading training manuals. Learning requires doing, with good feedback that leaves no ambiguity about whether you are succeeding—" I'm rolling along smoothly!"— or whether you are failing—" crash!"

As with anything, doing more of it doesn't mean you're getting better at it. You need to do more than just go through the motions. The way to get better is deliberate practice.

And finally …

"It is impossible to lay down binding rules," Helmuth von Moltke warned, "because two cases will never be exactly the same." Guidelines (or maps) are the best we can do in a world where nothing represents the whole. As George Box said: "All models are false. Some are useful."

The majority of traders spend most of their time on analysis. This is important of course. But we would benefit far more by spending our time dissecting and improving our analysis process. It's this "thinking about thinking" where true evolution comes from.

Macro and Markets

This week's Brief is light on market commentary because there isn't a whole lot worth talking about at the moment. And I don't want to report on noise — though there are a lot of interesting geopolitical happenings, of which I may write a separate piece about.

The market still looks strong, breadth is confirming its slow crawl upwards, though we may get a pullback soon.

We have the Fed and BOJ meetings this week.

The Fed meets on Wednesday and I don't expect anything new out of them as far as action. But I wouldn't be surprised to see a more hawkish tone and maybe a hint at a possible hike in September due to the strong data that recently came out.

The BOJ meets on Thursday and Friday, and they may very well do something crazy. They're increasingly becoming a wild-card. It's tough to predict when they're going to pull the trigger on what we see as inevitable at this point — zero coupon perpetual bonds. Kuroda likes to play a game of misdirection in order to surprise the markets, so we'll see. If they act and nuke the Yen, we'll quickly add to our long dollar exposure.

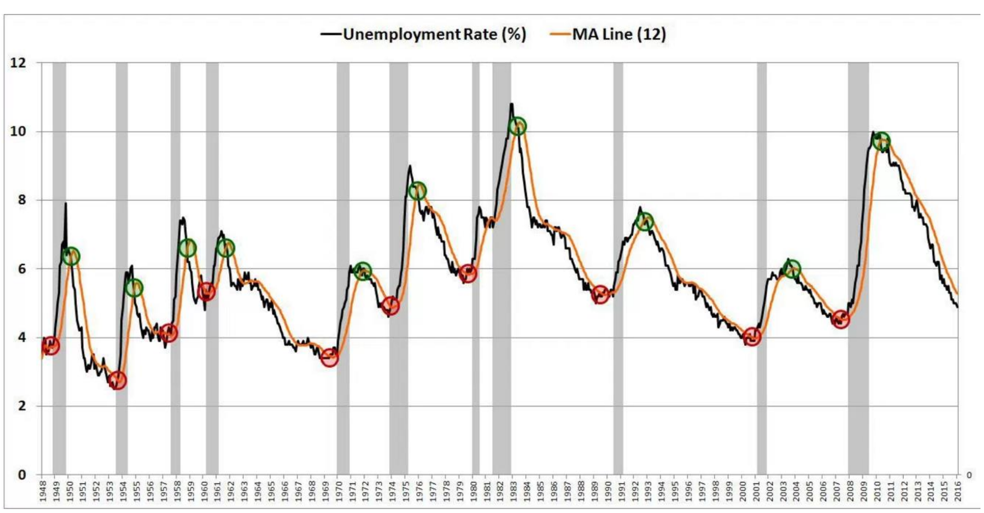
Our base case for US equity markets is still the late cycle sentiment driven rally. I think the reasoning behind this rally can be summed up by this quote from Taleb's *Black Swan*:

> *"It has been more profitable for us to bind together in the wrong direction than to be alone in the right one. Those who have followed the assertive idiot rather than the introspective wise person have passed us some of their genes. This is apparent from a social pathology: psychopaths rally followers."*

I believe this market is primarily driven by "career risk" and the last infusions of cheap money. This may end tomorrow, or in 12 months — it's tough to say and not worth trying to guess, we just have to follow price.

One of the best coincidental indicators of recession looks like it may be turning over. The indicator is the seasonally-adjusted US civilian unemployment rate with a trailing-twelve month moving average. It has preceded every recession (by an average of 3.4 months) over the last 100 years, except for 1937 and 1945, where it triggered a few months late.

You can go to Livermore's blog ([link here]) for a good discussion on it.



Some big things coming up

August is going to be a big month for us. We have some major upgrades to the service coming out in a few weeks. We're working on devving out some advanced macro and technical analysis courses and will be rolling out a new and vastly improved macro dashboard.

I'm finally finishing up a big project over the coming week which will allow me to start being a lot more active in writing and sharing analysis with you guys.

I've also got one of my good buddies working for us on creating a psychology and professional development course geared towards trading — this is an area that I'm super interested in. He's a Former Norwegian Special Forces dude who currently runs training and professional development for a large multinational tech company. The guy's a badass and somebody I always go to for advice on everything related to upping performance, so I'm pretty excited.

That's about all I got for now. Hit me up in the Hub or shoot me an email if you got any questions and have a good week!

- Alex

Portfolio Snapshot

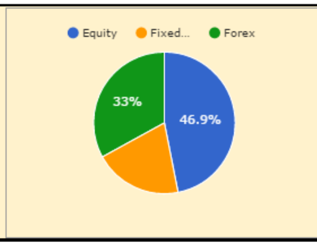
Macro Ops Strategic Portfolio

NAV $1,011,967.00

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Fixed Income	TLT	2500	132.87	128.98	$9,725.00	146.00	-0.32	$332,175
Equity	Cliffs (CLF)	6450	6.13	4.55	$10,191.00	14.66	2.44	$39,345
Equity	Chesapeake (CHK)	14700	5.15	4.30	$12,495.00	8.66	4.7	$78,654
Forex	USDCAD (6C)	-12	0.7603	0.7736	$15,960.00	0.7255	0.35	$910,260

Metrics

Exposure Breakdown	
Equity	$22,686.00
Commodity	$0.00
Fixed Income	$9,725.00
Forex	$15,960.00



Total Open Risk	Portfolio Beta
$48,371.00	0.04
4.78%	

*Updated 7/26

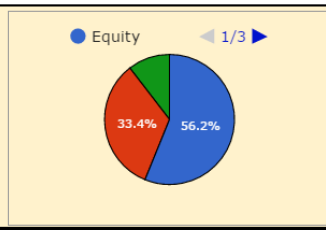
Macro Ops Tactical Portfolio

NAV $1,039,522.21

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Pampa Energia (PAM)	3400	24.40	23.31	26.55	$11,016.00	27.76	$174,896
Equity	Cliffs (CLF)	6780	6.12	5.00	7.99	$20,272.20	10.02	$41,358
Equity	Peru (EPU)	5935	32.09	30.80	32.92	$12,582.20	36.14	$190,454
Equity	Chesapeake (CHK)	16700	5.15	4.69	5.39	$11,690.00	6.90	$90,347
Forex	USDCAD (6C)	-15	0.7602	0.7654	0.7585	$10,350.00	0.7255	$1,137,875
Commodity	Cotton (CTZ16)	4	67.84	65.88	74.09	$16,420.00	77.00	$247,730
Commodity	Silver (SIN6)	1	17.05	16.36	19.68	$16,600.00	18.47	$173,300

Metrics

Exposure Breakdown	
Equity	$55,560.40
Commodity	$33,020.00
Fixed Income	$0.00
Forex	$10,350.00



Total Open Risk
$98,930.40
9.52%

*Updated 7/26

Macro Ops Income Portfolio

NAV $1,045,554.36

Asset Class	Position	Size	Cost Basis	Max Profit
Option	Aug 18 1960 Put	-10	$19.08	$19,080.00
Option	Aug 18 2016 2175 Call	-10	$9.18	$9,180.00
Option	Aug 18 2016 1465 Put	10	$1.56	(Hedge)

Scenario Analysis/Stress Tests

Worst Case	Worst Drawdown
SPX-10%	-$100,000
SPX-20%	-$250,000

**Updated on 7/26