CHAPTER 3

# "Fire in the Belly"

## *The Ability to Take Appropriate Risk*

Competitiveness is what former MLB general manager Frank Cashen called "fire in the belly." Competitiveness is that burning, inner need to win—not simply winning the game, but to win with every move the player makes on the ice/court/field. The competitive individual wants to score, wants to assist, and in short, wants to do everything possible to beat the opposing player as a key means of gaining personal gratification. It is somewhat separate from aggressiveness in that aggressiveness is simply the desire to hit. Competitiveness is the overall desire to win—to win with skill and/or to win with aggressiveness. In trading, competitiveness and risk-taking are two traits that go hand-in-hand. Truly competitive traders realize that in order to win they have to manage risk successfully.

## A PICTURE OF SUCCESSFUL RISK MANAGEMENT

Risk-taking is about a willingness to enter into the unknown, to take a bet based on insufficient information in an unpredictable market. Successful risk-taking behavior is the ability to take risk in a controlled way, follow the rules, manage drawdowns, cull losers, add to winners, express conviction in ideas in terms of sizing, and use capital appropriately. Most portfolio managers have the capacity to do this, but there is a range from those

who are very thorough and cautious to those who are swashbucklers. Some people are not compliant and need to be better controlled by persuasion; some people are risk averse and need to be encouraged to use more capital; some people are not adequately hedged and not risk-controlled enough. Some people hold onto losers too long. Others don't hold their winners long enough. Others look for an edge in little-known or -followed stocks (e.g., microcap stocks or small-cap stocks). These give them an edge but present liquidity problems such that if there are problematic or stress events in the market they cannot get out of their illiquid positions—not a good way to manage risk.

The successful trader, though, is a goal-oriented risk-taker with good abstract reasoning and not too much of the cautiousness or thoroughness that might interfere with his ability to trade stocks in his portfolio. The person's risk profile may be more cautious and thorough if he is going to be a long-term value investor. In that case, his cautiousness and thoroughness may support the kind of portfolio strategy he has developed to do very thorough work, to buy stocks when they are cheap and to hold them for long periods of time as they mature in value.

The best risk-takers are able to run balanced books, get bigger when they have an edge, and take risks in calculated ways. I look for people that are willing to take measured risk in their lives and are not so cautious and such perfectionists that they cannot pull the trigger. For example, successful traders know how to:

- Control downside risk and manage drawdowns by reducing the size of positions during times of loss or when approaching drawdown territory.
- Control downside by managing hedged books where they are not too long or too short in the way they are managing positions.
- Get bigger in high-conviction ideas and express high conviction by sizing their bets, especially before catalysts or critical events in the marketplace.
- Stay out of illiquid positions that make it difficult to sell stocks that aren't working.

The following are some general guidelines to help you assess risk-taking ability when interviewing someone or when trying to improve your own risk-taking abilities. Consider each category and ask the questions that follow:

## Trading Philosophy

You want to determine how conscious this trader has been in the creation of his career. Is he designing? Does he make things happen? Is he a maximizer or an opportunist? What motivates this trader? Is he aware of what motivates him? How flexible or how rigid is he? Can he adapt to various circumstances? Some of these things can be discerned from his career history as well as from his own formulation of his career. Ask the following questions to gain more information:

- What are your goals, strategy, outperformance targets, longer-term plans?
- How much has your career been governed or guided by a plan?
- Do you consider yourself achievement oriented?
- What motivates you?
- Can you give an example of pushing the envelope or stretching the boundaries in terms of generating ideas or in a personal activity?
- What would it take to motivate you?
- How do you motivate yourself?

## Handling Drawdowns

In order to gauge a trader's potential success, you must first know how he handles failure. You need to know how he handles stress and adversity, as well as his resilience and capacity to recover. Is he able to pace himself? How often does he make mistakes? Is his life a series of catastrophes, and if so, how much was he responsible for these problems? Does he have the ability to grow from adversity, to become an even better trader after failure? Is he risk averse? In addition, you want to judge his appetite for risk and, therefore, his personal growth potential. You may be able to discern the answers to these questions by considering significant events in his life history. You also need to ask:

- What are the two most significant elements of adversity you have ever faced?
- How much and how did you grow as a result of such experiences?
- What have you learned, and how have you changed as a result of such experiences?
- What kinds of things derail you?

- How do you typically respond to adversity? For example, are you prone to sulk, complain, or get aggressive? Do you give up or work harder?
- Do you stick to your conviction in the face of negative market responses?
- Give an example of how you knew to hold on or when you knew to get out of a specific trade?
- What did you learn from that experience? (Follow through on this, because some traders don't learn from a negative market response.)
- How much are you distracted by your own emotions (such as greed, fear, envy, jealousy, paranoia, or depression)?

## Head versus Heart

A successful trader is a unique mix of passion and dedication. His determination will create in him a desire to know more about his companies than anyone else in the world, but he will also rely on a certain amount of instincts that are the result of love for the job. Ask him:

- At what age did you begin to trade?
- Do you have a personal account?
- What attracts you to this job?
- What work do you do to ensure that you know your company better than anyone else?
- What makes your efforts unique?
- Can you give an example of how you used your gut instinct to make an important decision?
- How do you reconcile instinct and thought process in regard to decision making?

Although appropriate risk management is critical to successful trading, it is not a purely natural thing to do. In order to become a winning trader, a PM must be willing to review risk statistics with the risk manager so as to find ways of improving his overall performance, to examine personality factors that are likely to influence his risk management skills, and to explore various strategies that can upgrade his performance.

## Reviewing Risk Statistics

A winning trader must be able to function in terms of outsized performance targets. By looking at a trader's profitability or P&L, his percentage of

winning trades, his slugging ratio or W/L ratio, as well as his Sharpe ratio and other risk statistics from his previous job, it is possible to identify certain behavioral patterns that are reflective of his overall past performance (i.e., whether he doesn't take enough risk, takes too much, is not balanced, doesn't cull his losers, or doesn't get bigger in his winners). A lot of these factors are secondary to underlying psychological patterns, and from them you can make certain assumptions about future performance. If the individual has no prior track record, then it is important to review his life experiences for evidence of calculated risk-taking, goal-directedness, and the like. This, coupled with the use of psychological tests, can give you a sense of his or her ability to handle the uncertainties of the marketplace and deal with unpredictable events and insufficient information.

Of course, one of the most basic ways to assess a trader's ability to take risk is to examine his portfolio management. Although there is no unique way to structure a portfolio in terms of sizing, clearly, how it is structured is often reflective of the personality of the PM and therefore his ability to take risk.

Some PMs prefer to trade only a few, highly concentrated positions all the time (say between 5% to 15% of buying power [BP]). These portfolio managers are generally big risk-takers with a lot of confidence in their ability to trade and high conviction in their ideas. They tend to have large slugging ratios and outsized profits, but they also tend to exhibit lower Sharpe ratios and larger drawdowns.

The biggest danger for this style occurs when an overly confident and inexperienced portfolio manager doesn't reduce his position when the market says he is wrong and so suffers large drawdowns to the point of hitting his *down and out* (that amount of loss that triggers the dissolution of that manager's portfolio). This pattern often occurs among new and inexperienced portfolio managers who are trying to hit homeruns.

Another danger of this high-conviction portfolio style is the tendency to stick with losers. Most humans have the desire to prove themselves right. In some, that desire can lead to self-destruction. When some traders get in a hole, instead of getting out, recouping, and starting over, they hang on, even adding to losing positions in hope that their "luck" will change, that the position will turn around and they will recover. Unfortunately, the opposite is often the case. They wind up losing everything.

Take Cameron, for example. Cameron is known for closing out winners early and sticking with losers too long. In 2006, he was down $8 million—$6 million of which was attributable to one position. He made

$6 million in the position in the previous year and continued to believe it was a high-conviction idea in the next year despite the fact that the market didn't show its normal seasonality in early January even with positive data and good earnings. The company reported a decline in gross margins that knocked the price down, but Cameron didn't risk-manage the position or put in stops so as to preserve some of his profits from the previous year. The stock continued to decline in price, and he continued to hang on, eventually giving up all his profits. Even with his losses, Cameron admits that if he weren't down so much he would have been buying more.

Of course, a set of constraints should generally be established that PMs should be expected to follow. An example of one such set of constraints might be as follows: no more than 10 percent of the portfolio with more than 2 days of trading volume; 7 percent for 5 days; 5 percent for 10 days; and 2 percent for 20 days. This means that the PM should not have more than 10% of all his positions that take more than 2 days of trading volume to exit the position, and so on. This is not onerous, but some PMs experience it as such.

A case in point is Chris. Chris was running 50 names—most of them low-conviction ideas. He tended to focus on low illiquid-cap stocks that were barely covered by investment analysts at brokerage firms and investment banks. Managing illiquid stocks can be profitable if things move up but can be problematic if there are catastrophic events and the stocks plummet.

Chris had a large position in a small biotech company that he was selling. The path to getting paid was his expectation that it would be sold to a larger biotech company. The problem was that this position was illiquid, and illiquidity hurt Chris's ability to do something in other stocks. Chris noted that he had an edge in less-trafficked names because no one else knew about the stocks and he had an edge on the competition, but this created a risk for the firm. If too many PMs took this approach and got into too many illiquid positions, it would be difficult to deliver in the event of a catastrophe in the market, as happened in the summer of 2007 during the subprime mortgage and credit crunch debacle.

Another portfolio consideration to look for is the trader's drawdown control, a vital indication of whether the PM has good risk management techniques in place and is able to recognize when he is in drawdown and can take appropriate measures to reduce his losing positions and the chances of getting into even greater drawdown. This is an important portfolio management skill that PMs need to follow and demonstrate before

anyone would want to give them more capital. It suggests discipline and good corporate citizenship. Most important, it means that the PM is not being run by his emotional responses, leading him to do foolish things such as double down when things aren't working. It is also important that the PM deliver before drawdown limits are reached, and in particular, not hold onto losers.

The following are some more basic considerations to examine within a trader's portfolio in order to get a better idea of how well a trader manages risk:

- **Long stocks only:** Does the PM have a lot of ideas on the short side? Does he hedge himself with equity indices on the short side to stay within his net market value (NMV) exposure limits? Is he implicitly making sector bets by employing a broad-based index hedge instead of finding not only long alpha plays but short alpha plays where no single-stock shorts can be identified? A good approach is a custom basket in his sector.
- **Poor alpha generation:** Performance should be viewed relative to the performance in his sector. Some portfolio managers may appear to be doing well when, in reality, a large portion of their P&L is simply generated when they are long and their sector has run strongly, not because of stock selection.
- **P/L distribution:** Sometimes returns are dominated by one or two positions for the entire year. This could be a problem if these one or two outsized P&L results are not repeatable year after year. A distribution of P&L where the magnitude of the top winners—trade by trade by trade—exceeds the magnitude of the top losers is preferable. This results in a P&L distribution that is skewed to the positive or right side and is an indication of a repeatable process and risk management style.

Of course, there are times when an individual doesn't have the specific career or life experiences to evaluate the above criteria. Then it becomes essential to evaluate them psychologically as well as in terms of their life histories.

## Examining Personality Factors

Whereas an individual's past history can provide a clue as to how he is going to handle decision making in situations where he has insufficient

information and how he is going to manage toward greater performance, his personality can also play a significant part in how he takes risk. If an individual is too cautious or too thorough or in a psychological sense too much of a perfectionist, he is likely to have difficulty in adapting to a goal-oriented, high-performance approach to portfolio management. In addition, it is important to screen out traders who are too impulsive, impatient, and perhaps irrational risk-takers who lack sufficient cautiousness and thoroughness to prevent them from blowing up.

In doing so, you must consider personality proclivities to determine whether they will be able to adapt to the challenging role of portfolio manager. It is also important to evaluate how they handle work assignments during a two-to-three-month evaluation period, when you can observe how they prepare, then report and respond to constructive criticism, as well as how they interact with members of your team. This type of evaluation will give you the best sense of how they are likely to do. One fund manager I know claims it takes him three years to really make up his mind as to whether someone will be ready for the long haul. The following are a few examples of different personality profiles to give you some idea of the kinds of considerations that are useful when evaluating an individual in terms of managing a portfolio.

**The Stubborn Risk-Taker** Rebecca is an urgent risk-taker who may be a bit stubborn in her approach to risk-taking and not too coachable. She is a very self-assured trader who exhibits a forceful leadership style. While she is more than willing to challenge the status quo, she demonstrates a sense of urgency that may manifest in impatience with time on the job. Her stubborn nature may lead her to believe that her way is the best or only way of doing something, thus limiting her capacity to benefit from the suggestions that others bring. Moreover, as she tends to be rather skeptical of people's intentions, she could build walls that discourage a give-and-take relationship. Still, she is very calculated and responsible in her actions as well as very results oriented.

While she addresses issues immediately, if she has a particular plan in mind, she might not consider outside resources that could add to the richness of her recommendations. A born competitor, Rebecca displays the analytical ability to perform well in a portfolio management role. She is apt to seek out new and creative means to achieve strong returns and shows the decisiveness to take advantage of opportunities as soon as possible.

Philip is another stubborn, long-term value-oriented PM. He gets attached to ideas, especially illiquid ideas, and holds them too long. He doesn't follow good risk management principles. His winning trade percentage is 46 percent and basically not good across all holding periods. He has high-conviction ideas but seems to hold onto things out of belief even when they are going against him. Nevertheless, he has a high slugging ratio (the amount of profit he makes in his winning trades over the amount he loses in his losing trades) and obviously understands his stocks in some big, macro way.

Unfortunately, he tends not to be able to grasp the message of risk. He is holding good ideas too long and keeps holding them as they go down in value, giving back much of the profit he has made. His tendency to hold on a long time to losers is reflective of high conviction but not good risk management. His extreme illiquidity (being in stocks that take several days to liquidate because they don't trade that many shares a day) puts his portfolio at great risk. Some of his biggest trades will take 15, 25, and 40 days to liquidate, which could be disastrous for him and for the firm if there were a catastrophic event. He was unable to define a timeframe and delineation of the path to getting paid for many of his stocks in terms of specific catalysts, which would help give him more conviction and enable him to build up in size. Traders like Phillip may hold onto losers too long, getting themselves into a deeper drawdown because of an unrealistic hope that things will turn around.

**The Reserved Risk-Taker** Some traders fail to utilize all their buying power and don't size their high-conviction ideas. Patrick is one such reserved and cautious trader. He is covering a universe of 200 stocks, has an elaborate screening process, and is basically trading not to lose. He mentioned that in the past he had done better, but he got off to some early losses and played defense the remainder of the year. He did make money in the second half of the year and ended up $7 million. His risk manager indicated that Patrick had done 3.7 percent returns on gross market value (GMV) while the minimum target on buying power should be 12.5 percent with a Sharpe of 1.5. He noted that Patrick had a low batting average (45%) and a low batting average in all time buckets. Despite this, he had a good slugging ratio, making on average more in his winners than he was losing in his losers. He is conventional in his approach and doesn't usually incorporate a broad range of ideas into his decision making.

Patrick is most comfortable when he feels things are under control; so he is inclined to monitor and track the progress of his activities. While he is often timely, he is also reluctant to let go of the details of a trade and may sacrifice efficiency for exactitude. He displays a highly structured, disciplined approach to making investment decisions and will consider the information at his disposal in great detail and systematically evaluate each opportunity. His high standards and cautious tendencies suggest that he will make consistently reliable decisions over time. However, he is not likely to be creative in looking for new opportunities or developing investment strategies. He is formulaic in his approach to risk and reluctant to consider ideas that do not have a proven track record or that do not conform to his preexisting notions. He would be able to act more quickly with fewer names, indicating that he might do well with 15 longs and 15 shorts as opposed to the 20 longs and 20 shorts that he had last year. After much discussion with his risk manager, Patrick finally (reluctantly) committed to a reasonable target of $40 million on $200 million of capital.

Indy is another cautious trader. While he has terrific statistics, a high Sharpe ratio, and excellent drawdown statistics, he is obviously reluctant to get bigger and use his BP. He gets out of all his positions when there are any macro events rather than holding onto his high-conviction ideas. We explored this theme and focused on his inability to deal with loss and the anxiety he experiences when there are small drops of P&L. He is very focused on his daily P&L and was looking for help in finding a way to get bigger.

This pattern was also demonstrated by Toby, who has a well-thought-out process and sound portfolio management construction but is still relatively cautious. This shows up in his good drawdown stats, the absence of illiquidity, and his tendency not to utilize all of his buying power. His statistics in general are average, except that his drawdown management is in the 91st percentile. He had relatively weak performance in his longer-dated trades and only 50 percent of his trades registering as “winners.” While he showed a good distribution of conviction, it was clear that he, too, needed to better utilize his buying power limits.

While some traders demonstrate cautiousness in terms of sizing and deploying capital, others show their reserved personalities by trading in illiquid positions. For example, Toby finds it hard to find high-conviction ideas and good shorts. He has not been very successful in finding catalysts. Based on his stats, it appears that his usage of buying power was down, his names were down, and his statistics in general were average. That

being said, he had a good percentage of winning trades, but his slugging ratio was low, and there was a tendency toward illiquidity in his portfolio. Toby expressed awareness that he was more active in illiquid names and noted that he was trying to manage his drawdown by selling some. Still, 13 percent of his BP was greater than two days of average daily volume, and he wasn't using all of his BP. Toby obviously needed to find more ideas so he could put bigger positions on the books.

Another example is Jeff, a deep-value PM who has to learn to increase idea velocity and be more focused on P&L results, targeting and getting out of losing positions and getting bigger in high-conviction ideas. He has been struggling to adapt his long-term, deep-value technology investment style to a more goal-oriented hedge fund and has been experiencing some pressure to increase the number of ideas and improve his timing. Shorting has been a problem for him since the value longs don't move with the market, and it has been hard to find shorts. He has relied on IWM indexes but is moving toward using baskets of nonconcentrated shorts. Jeff has begun to look for more short-term catalysts than he has in the past and for names that move.

Up until now, Jeff had 31 completed trades with 20 being in the 21- to 60-day bucket. His percentage of winning trades is 20 percent with a big loss ratio and the possibility that he takes his names off too soon. His book is skewed to the left with losers being bigger than winners. It was suggested that he put more ideas and names into his book. It was noted that once Jeff develops a repeatable and successful process his book will skew to the right. In the 61+ bucket he had 5 trades, three of which worked.

Jeff seems to be a bright guy who is very cautious and tentative but slowly coming around to looking for greater idea velocity, more focus on short-term catalysts, and a greater willingness to redeploy capital into ideas that seem to be working rather than simply buying cheap and holding for the long haul.

**The Anxious and Insecure Risk-Taker** Other traders aren't necessarily cautious—they are just fearful or insecure. Morgan, for example, is a very analytical person who weighs the available options, focuses on the details, and considers all the possible consequences. His extreme attention to the "fine print" leads him to be very responsible but also very insecure, relying on conventional approaches rather than innovative methods. Though Morgan prides himself on his ability to manage details, it is a trait that leads to delays in his effort to move tasks and projects forward. He

has no sense of urgency, and given his desire for structure, tends to be somewhat of a perfectionist. This can lead to indecision and an inability to function without sufficient information. While Morgan's research abilities would be highly beneficial, he will find it difficult to take risk without some measure of reinforcement. In addition, because he is often slow to act, he may lose out to competitors who are more action oriented.

Another trader, Braxton, is simply afraid of losing. He is afraid of having his capital cut. He is afraid of being fired, and his fear is affecting his performance. Although Braxton is relatively successful and knows how to cut his losers and hold onto his winners, he plays defensively and isn't taking an adequate amount of risk. Despite the fact that he is up about $12.5 million for the year, he rarely uses his capital and has been running between $1.5 million and $2.5 million of his designated $4 million VAR. He has been a successful countertrend trader but admits that he is fearful that if he gets bigger he will lose more and that if he loses too much money he may be fired. He is projecting his own fearfulness onto the firm, even though the boundaries are pretty well-defined, and he has always been guided to make money in a risk-controlled way.

To improve, Braxton needs to make a conscious effort to commit to taking positions that are 10 to 20 percent bigger, since his success up to this time points to the fact that his risk management is good and that if he used more capital and took bigger positions his profitability would increase. He is now feeling more confident about starting to size positions when he has conviction and wants to stop playing defensively.

Some traders demonstrate their insecurity by selling their winners too early, a pattern that typically appears in a holding-period analysis. Here, the winning trade percentage may greatly exceed 50 percent and be quite outsized. However, the average P&L per trade is very small (or negative), and the slugging ratio is very small. The implication is that when the trade becomes a winner, the portfolio manager sells too quickly, thereby not making enough profit to offset losers, which in turn can be outsized.

Some risk-averse PMs are inclined to be more comfortable holding a larger number of positions where no particular position is large (say, less than 2.5% of BP). They are not putting enough of their capital at risk in any one position. There is an underlying risk aversion in these traders, many of whom are quite successful in this approach. However, I mention this because it may reflect that the traders are relying on certain personality tendencies rather than a rational strategy based on a full understanding of

the risks and stats. These portfolio managers tend to exhibit higher Sharpe ratios, winning trade percentages, and better drawdown control, but they also tend to exhibit lower slugging ratios and tend to put on too many ideas. Therefore, there is a danger that there is not enough capacity for the portfolio manager to differentiate among positions and really obtain an edge in the positions he is trying to follow.

Belton is a good example of someone who needs to do the right kind of work in order to maximize risk. After reviewing his positions last year, Belton discovered that if he excluded his top 10 winners and bottom 10 losers, 70 other trades netted him hardly more than $1 million. He put a lot of effort into a lot of ideas that never amounted to much. His best results were with high-conviction ideas where he had done the work and had the thesis right. This year, he intends to focus on high-conviction ideas where he can put on $8 to $15 million and skip the $1 to $2 million trades. He will run a hedged book but basically be less net long or net short than he was. He believes he can do well with one good idea per month. He is planning to make a few concentrated big bets, hedging them with good shorts. He has no problem finding stocks to short as hedges. He has learned to add to winners and to reduce the size of losers rather than buy losers.

Anxious, insecure, and cautious traders often need to be encouraged to take more risk, something that should be done based on levels of conviction and sized commensurate with the amount of profit that they want to make. This is where I spend a lot of my time encouraging people to *do more work*, to think outside the box, and then to take the risk necessary to make specific amounts of profits.

**The Perfectionist Risk-Taker** The perfectionist risk-taker is often smart and knowledgeable and mistaken for being extremely cautious. In reality, his risk-taking style is defined not by a cautious nature but by his perfectionist tendencies. A trader has to be cautious, but *cannot* be a perfectionist. If he waits for perfect information, crossing all the *t*'s and dotting all the *i*'s, he may not be able to make decisions in a timely fashion. This may work for some analysts, but not for portfolio managers.

Take Marc. Marc is a good performer, highly intellectual, and stubborn, which leads him to be too cautious about using all his capital. Marc has excellent statistics with high winning trade percentage, minimal drawdown, good shorts, and high-conviction ideas. But he generally uses only part of his buying power (about 60 percent). Liquidity is not an issue; his liquidity

is less than 10 percent of daily volume in most of his positions, and his Sharpe ratio is 3.5. He could certainly take more risk and increase his P&L substantially while maintaining a high Sharpe. His 2 percent drawdown is exemplary, and there is no fear that he will have a significant drawdown if he takes more risk.

But Marc is uncomfortable with his highest-conviction ideas; he starts to question his thesis and begins to find elements that suggest the conviction isn't justified. He actually feels more comfortable with his medium-conviction ideas. He admitted that if his capital were increased he would take more risk, although probably still remain at 60 percent of his buying power, suggesting that perhaps he would use more capital if he had even more buying power. As you can see, his perfectionist streak makes it almost constitutionally impossible for him to go full bore against his buying power.

While successful, he could be extremely more so if he would learn to take a little more risk. He has some of the best statistics in the firm but doesn't use all his capital or put on too many high-conviction ideas. Why? Because he is generally waiting until he gets to 85 percent conviction before he sizes his positions. Since he rarely gets to that level of conviction, he is reluctant to put on his positions in size. To motivate Marc, he has to be reassured that it is okay to use more capital. He needs to be convinced that he will do just fine if he sizes positions where he has 65 or 70 percent conviction, especially given the strength of his trading stats. It was also suggested that he try to get more names in the book and that he begin to size them as well in the effort to take more risk. One year after our discussion, Marc was running more money but still showing the same perfectionist tendencies.

Donovan is another example of a perfectionist risk-taker. He doesn't use his buying power and rarely sizes his ideas in terms of his level of conviction. He has very few high-conviction bets. When challenged about trading to win rather than trading not to lose, he talks about *developing* the process and taking a year to get up to full use of his $100 million of capital. His rationalization for his approach is based on his need to take his time to scale up and his concern for liquidity constraints. His slugging ratio is very low, and it is clear that if he continues to get 60 percent of his trades right and size them correctly and hold them he could increase his profitability. Donovan expressed concern that sizing positions too big might run a risk of a major drawdown if a number of them failed. A probability distribution with binomial expectations showed that the probability of a string of

even five losses was negligible, suggesting that Donovan's issue is more of gut-instinct than of mathematical rationality.

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Everyone has a different personality, and personalities are destined to affect how we manage risk. Still, whether stubborn, reserved, anxious, or perfectionist, the best PMs are independent decision makers with an appetite for risk. However, those same characteristics also make for a tendency to break the rules and take bigger chances than risk management believes is wise. So, even if a trader has an excellent personal history and a personality fit for risk-taking greatness, it is still necessary to make sure that risk-takers adhere to the risk guidelines of the firm and don't become total buccaneers.

## LEARNING TO UPGRADE YOUR PERFORMANCE

Unfortunately, not all traders recognize the importance of risk management. As obvious as it would seem to be, many traders simply dismiss or undervalue how vital it is to success. Alex is one such trader, and his inability to manage risk is evident in his current frustration. He believes he could be bigger but has reached his limit on sizing (15 percent of his portfolio). He is also net long about 35 percent (also at his limit). He believes his volatility at 6 percent is not that high and that he is "right" even though he is in a huge drawdown. He believes that long term his ideas will be right and cannot understand why the firm won't hedge out his risk. I confronted him about this and strongly advised him to follow good risk management principles and try to keep his losses down to stay in the game. While he was very appreciative of the attention and support and appreciates the importance of risk management, he is still of the mind that the risk manager cannot understand what it feels like to trade ideas when you have done the work. I talked to him about establishing a template for assessing shorts from a stock-selection and risk-management viewpoint—combining fundamentals and technicals, looking for companies with bad accounting, low multiples (with high expectations), and smaller caps. In all this, he needs to learn to raise his threshold of awareness of what constitutes a good short and how to manage risk better. I indicated that it was up to each PM to

control his own risk and suggested that he get some better idea of how to assess his volatility.

It is very important that PMs learn early on to stay within their limits. Limits are in place for the benefit of the portfolio manager as well as for the firm. In the event that a particular opportunity presents itself to any portfolio manager that would put the manager outside of some pre-agreed limit, the portfolio manager should discuss the opportunity with risk management. Decisions about whether to exceed any limit are at the discretion of risk management. This was the essence of a conversation I had during a PM review with Samuel.

Samuel had a problem staying within the defined limits. This became especially significant in periods of major drawdowns in the markets when not only did he put himself at risk but his firm as well. This pattern emerged in 2006, and was again apparent in midyear reviews in 2007. Essentially, it appeared that Samuel didn't think the rules applied to him; therefore it was necessary to confront him about this until he acknowledged that he would play by the rules. Samuel needed to learn how to recognize drawdown triggers and to start conversations with risk management about delevering his portfolio in an effort to catch his losses early enough in the process to prevent a serious drawdown.

The big thing in managing a portfolio is to keep the NMV within reasonable limits—meaning that the book is hedged to take out the market risk. So when the gross market value or the capital is increased, sometimes the net is reduced, which means that the portfolio has to be run with a hedge on, so many shorts to balance out the long and not more than 20 or 25 percent of the portfolio in shorts. So, someone running a hedged book might have $176 million in longs and $94 million in shorts, giving them $82 million or the difference between the longs and shorts as their NMV, meaning that they have only $82 million in exposed long positions. This is the way a PM can deploy more capital and yet do it in a risk-managed way.

Of course, not everyone is willing to run his book in terms of these risk constraints, so eventually the risk manager will not apportion more capital to the trader if he goes over the net limits. This sometimes works as a way of keeping traders in line. Sometimes it doesn't work, especially when people have difficulty hearing criticism and adhering to rules.

Too many traders don't understand risk-taking in a managed way. It is important to take risk in a big way but only when you have built up a reserve of capital. I like to point out how important it is to follow risk management principles, certain statistical metrics to make sure that the

trader is doing what he ought to be doing and maximizing his trading strengths.

Consider Chuck. Chuck has been having a hard time. He is down about $3 million for the year, and his buying power has been reduced from $50 million to $35 million. For the past six years before coming to the firm, he focused mainly on directional bets, playing momentum and flow. This strategy no longer seems to be working, and he is trying to find a new approach that is profitable. He has lowered his yearly target from $10 million to $5 million, which means he needs to make $50,000 per day to overcome his present loss and reach the target of $5 million. He is well aware that his performance as a PM has been substandard, but attributes it to difficulties of the market.

We talked about running a more concentrated portfolio built around companies that he knows, sizing down his positions relative to his capital levels, reducing his conviction sizing, and diversifying his portfolio so that he can work his way back up. I suggested that he needs to be more proactive in reviewing his portfolio daily to find imminent opportunities and to see what he missed and what he needs to incorporate into his process to increase his hit ratio.

As we discussed in the last chapter, you have to develop a goal and a strategy for reaching that goal. Part of that strategy involves laying out in a detailed way how you plan on handling risk. Even traders who are doing well can find an area in which to improve.

Adam is up about $4.7 million for the year. He is definitely feeling more confident about his performance and continues to focus on getting bigger in high-conviction ideas where he has done the work, to pare down when the ideas aren't working, and to keep getting out of stale shorts and not let them bleed too much. He manages his capital by managing each position and the overall portfolio.

To the extent that his stocks move in tandem and in response to macro events, he tries to manage his overall exposure in terms of basic material risk. He knows the supply/demand curve in most of his metals and is able to integrate this knowledge into his trading approach. But he doesn't believe that he can find any more macro inputs that would help him anticipate the moves in the market, although his biggest drawdowns have been secondary to macro moves.

While Adam has become more nimble and thinks that he is sensitive to these issues and can handle them, the problem is that the macro lead indicators keep changing with different implications, so that it is hard to

prepare in advance for them. In discussing illiquid stocks, he noted that the best-valued stocks are generally illiquid and at the lower end of market-cap scale. The best opportunities are in the lower-cap names. He also noted that he prefers this game since he doesn't think he is good at the momentum game, which drives the more liquid, larger-cap stocks. So, he has a very good conviction and idea flow but needs some tweaking on closing out positions on ideas submitted. He has agreed to work on the template and high-conviction criteria, and to provide portfolio updates in order to improve these areas of risk management.

Another critical issue here is generating enough original ideas to populate the portfolio with high-conviction ideas that are going to move far and produce certain probabilistic results by way of achieving a stated goal or target. By reverse-engineering a trading strategy, based on the expected results, and calculating winning percentage and W/L ratio, the portfolio manager ought to be able to determine how many ideas he needs to generate and what kinds of returns he can expect in each of his positions. This goal-oriented approach acts as the driver of the research process and the quality and velocity of ideas that must be generated. Paul, who manages a large team of analysts and portfolio managers, explained to me recently how he has created a system to help him manage risk in this way:

> *You have to start your hedging on an idea-by-idea basis. We have a system where I have grouped every bet on the short or long side of a book to balance risk. I look at the net exposure of that group. I know when I roll that all up I can look at the net exposure of the portfolio. By looking at it on a position-by-position basis, then rolling it all out, you actually get a more true risk management between your longs and your shorts. How do you come up with a hedge on it? Recognize that one answer might be, there is none, and this has to be your directional exposure. How do we think about a hedge and then fill a position? Break it down qualitative and quantitative. On the qualitative side, the question that I ask is, "What is it about the bet that I am making that's outside of management's control?" The quantitative way is to basically do a search for companies that have a high statistical correlation to the position that you have. Then you can go through and say, "Which of these fit into the qualitative issues, the qualitative factors that were identified?" When you can actually come up with the best cases, a basket of ten to twenty names that are exposed to the same factors, update them on a day-to-day basis and*

*see if they move in the same direction. The last component is, how volatile is that basket relative to your name? Correlation of positions shows your direction. Volatility is going to show you magnitude.*

*It's going to be easy to find longs; so at least this gives you an option to responsibly manage risk. Instead of having ten longs and ten shorts, you are actually increasing your idea velocity at some level by not having to find a lot of marginal stuff to populate a portfolio. You are getting more concentrated, but you are not doing it in an irresponsible way. You are not going to have big drawdowns for market-related reasons. It's a way of gaming a system and making it easier.*

Of course, sizing, like most aspects of trading, can also be a very emotional one. Traders tend to fall in love with ideas and size them according to their level of affection. Unfortunately, this often leads to an unhealthy attachment so that when events happen and the position turns against them, they fail to get out. In fact, they often wind up adding to losing positions and in a deeper hole. In addition, when they do get out they are so emotionally spent that they are unable to get back in the game in a timely manner.

Paul tries to keep himself at a safe distance from such emotional attachment:

*I am going to cut the position that I love because I just lost too much money. I have enough confidence in my ability to make money over time that I don't want to be emotionally attached to one situation and have that be my focus, be my whole life. We are trying to predict the future. As long as you have cash, you can play. You can earn back whatever you lost and make a rate of return. Once you get to dollar zero, its game-over for you. Some people have unlimited risk tolerance and don't care how much they go down. They only respond to cutting positions when the risk manager taps them on the shoulder. That's not a good way to approach trading. A better approach is to cut positions when things aren't working, just for the sake of moving and getting into an offensive mindset. The whole point of it is to get freed up into positive situations and not spend time on these negative situations that are going to draw in emotional energy.*

Like Paul, the master trader will not invest himself in any of his ideas. He will not allow himself to believe that his decisions define his personality.

While he is concerned with the results, he doesn't allow that concern to lead to bad decisions. He will not size a position solely based on how he feels about it, and he won't stay in a losing position just to prove a point.

So, when sizing positions, first consider how much money you will make if your position turns out to be right. For example, if one position will, at best, make 30 percent and another will make only 5 percent, why would you size them the same dollar amount? Size them appropriately relative to the percentage you expect to earn from them. Then, when a trade is not going your way, take the time to consider what you did wrong. Think about how you reacted to the circumstances. To be proactive, prepare yourself for a variety of scenarios by actually visualizing different events and how you will react to each one.

Of course, experience plays a large part in risk management decisions as well. As you develop more experience, you will have a wider spectrum from which to draw ideas and other resources as well as a better handle on how to navigate the difficult trading waters.

Again, referencing trading statistics is also useful in underscoring the kinds of things that are working and aren't working and to begin to suggest what you must focus on to produce improved results. It is important to note that the risk manager's view is that you need at least six months of trading stats to begin to develop a trading profile so as to be able to have an intelligent discussion with a PM. Whereas these statistics point to trends and patterns that you should be conscious of, in the vast majority of instances you cannot simply modify your trading so as to produce better stats. You need to understand what you are doing and try to take these things into consideration as you begin to manage a portfolio.

Understanding the statistics in and of themselves is not sufficient to be able to provide a blueprint for success. It is no different than baseball stats. If the batter strikes out a lot, it is important to point that out to him, but you don't go from the strikeout statistic to batting technique. You find ways of improving your performance by gathering data, evaluating the path to getting paid, and paying attention to drawdown propensity or your personal tendency toward illiquidity and to your holding periods so that you can begin to do the kinds of things that will increase your chances of success.

Portfolio management must be wedded to a research process. You have to find original ideas in a strategically based approach to what has been called the *variant perception*—nonconsensus ways of seeing the world and the markets that provide for a differentiated and positive view

of stocks. This requires an additional skill set of seeing around corners, dealing with the unknown, and being able to work with insufficient information and perspective by creating an original way of looking at the world. We will explore this strategic, original way of thinking in the next several chapters.

## CHAPTER IN REVIEW

1. Successful risk-taking behavior is the ability to take risk in a controlled way, follow the rules, manage drawdowns, cull losers, add to winners, express conviction in ideas in terms of sizing, and use capital appropriately.
2. The successful trader is a goal-oriented risk-taker with good abstract reasoning and not too much cautiousness or thoroughness that might interfere with his ability to trade stocks in his portfolio. He is able to run balanced books, get bigger when he has an edge, and take risks in calculated ways.
3. You can learn to assess risk-taking ability by considering a person's trading philosophy, how he handles drawdowns, and the certain mix of passion and dedication within himself.
4. In order to become a winning trader, a PM must be willing to review risk statistics with the risk manager so as to find ways of improving his overall performance, to examine personality factors that are likely to influence his risk management skills, and to explore various strategies that can upgrade his performance.
5. By looking at a trader's profitability or P&L, his percent of winning trades, his slugging ratio or W/L ratio, as well as his Sharpe ratio and other risk statistics from his previous job, it is possible to identify certain behavioral patterns that are reflective of his overall past performance. A lot of these factors are secondary to underlying psychological patterns, and from them you can make certain assumptions about future performance.
6. Personality can also play a significant part in how a trader takes risk. If an individual is too cautious or too thorough or in a psychological sense too much of a perfectionist, he is likely to have difficulty in adapting to a goal-oriented, high-performance approach to portfolio management. In addition, it is important to screen out traders who are too impulsive, impatient, and perhaps irrational risk-takers who lack sufficient cautiousness and thoroughness to prevent them from blowing up.
7. Even if a trader has an excellent personal history and a personality fit for risk-taking greatness, it is still necessary to make sure that risk-takers

adhere to the risk guidelines of the firm and don't become total buccaneers. Therefore, it is very important that PMs learn early on to stay within their limits. It is important to take risk in a big way, but only when you have built up a reserve of capital.

8. As discussed in the previous chapter, you have to develop a goal and a strategy for reaching that goal. Part of that strategy involves laying out in a detailed way how you plan on handling risk. Even traders who are doing well can find an area in which to improve.