

A Tale of Three Traders

The financial news has been filled lately with talk about the French rogue trader that lost a record US\$7 billion dollars. Many analysts have weighed in with their opinion that this type of event is unusual, that this is an isolated case. While it's true the size of the loss associated with this event makes it a bit unusual, what this trader did was hardly unusual, and you might be surprised when I say that many individual traders possess the same weaknesses and character flaws that allowed this trader to lose this much money speculating for the French Bank Societe Generale. How do I know it's a much more common happening than the press and officials would have you believe? Read on and I'll tell you about three such events that happened while I was managing professional traders at US Institutions [Note: There were many more such incidents I witnessed over the years at the institutions I worked at, and that the names and circumstances given here were changed enough in the telling that no one and no institution could be recognized, nor could their reputation be damaged.]

Karl was a well-known currency trader. I had made many cash currency trades with him over the phone before we were both working at the same US bank. I'll say one thing about Karl: He could make money faster than any trader I have ever known, before or since. And he loved to trade. In the early 1980's, before cell phones were invented, Karl had a two-line phone installed in each of his bathrooms at home so he wouldn't miss a call from a trader around the world if he were in the bathroom making a trade on the first phone line! Karl was a trading junkie, pure and simple. He lived to trade.

Our manager was away from the trading room one Monday morning, visiting the head office for the entire week. There was no need to name anyone to take his place while he was gone. Though our manager was the nicest guy in the world, he gave us all strict intraday stop-loss limits and overnight position and stop-loss limits and made it clear that if they were ever violated, we would be fired with no questions asked. He had a black binder at the end of the trading desk and you were expected to write down each day's profit or loss and your overnight position before you left for the day. And of course, then you had to sign your name next to what you had written.

The markets that day were completely crazy. Several hours into the trading day, one of the marketers motioned for me to come over to speak with her. I assumed she had a client on the line that needed advice or wanted to speak to me personally. Instead, with a hushed voice she told me to go back to my desk, wait a few minutes, and then get up and walk into our manager's office, close the door behind me and call him at the head office. When she recognized the look of puzzlement on my face, she told me quietly not to tell anyone what I was doing.

When my manager answered the phone, he got right to the point. He asked me if I had any idea what Karl's position size was at the moment. Karl sat across from me but the desk was noisy enough that unless you made an effort to ask someone what he or she were doing in the market, it wasn't particularly easy to know—especially if you were busy trading your own position. I told my manager that I honestly had no idea what Karl's position size was. Then he asked if Karl was having a good or bad day. Glancing out the window, I could see that Karl was hunched over the desk, smoking his fiftieth or sixtieth cigarette for the morning, with a phone stuck to his ear. This was how Karl looked throughout the trading day. Again, I told him I really didn't know.

My manager took a long, deep breath and then paused, and told me that he had just gotten a call from one of Karl's cash currency brokers. The broker told my manager that by his estimation, Karl was down several million dollars and was probably carrying a position that was well over ten times his intraday limit. At that point in my career, my intraday loss limit was \$100,000 and I assumed Karl's limit was similar in size. My intraday position limit was US\$20 million dollars and again, I assumed Karl had a similar position limit. If this broker was telling the truth, Karl was well over his position and loss limits.

I asked my manager what he wanted me to do about it. And when he answered, I wasn't wild about the idea. He told me to walk out to the trading room, go over to where Karl was sitting smoking his cigarette and quietly tell Karl I had just gotten a call from home and needed to speak to him privately out in the hall. Then I was to do my best to find out his real position and what his current P&L was. And if he was in as deep a hole as the call from the broker had suggested, I was to find a way to get Karl to take a walk to clear his head and while Karl was out of the room, I was to call my manager back with what I had found out.

I hung up the phone and took my own deep breath and then slowly walked over to where Karl continued to hunch over the trading desk, chain smoking his cigarettes. As soon as Karl noticed I was standing along side him, he mumbled into the phone that he had to go and then gave me a weak smile and asked, "What's up, Tim?"

Going along with my manager's plan, I softly told Karl that I had just gotten a call from my home and I needed to ask his advice out in the hallway. Karl glanced at his quote screen, grabbed his packet of cigarettes and his lighter and said, "Sure, let's go," and then he led the way out of the trading room into the hallway. Once the trading room door closed, he asked me if everything was alright at home. I paused for a second and then told him that I had just gotten a call from our manager and that he was concerned about the size of Karl's position and the mounting losses.

I'll give Karl credit: I feared he would become irrational and perhaps even get angry enough to become violent, since someone had obviously "ratted him out." Instead, I watched as all the energy drained out of his body. He closed his eyes and murmured, "I can't lose this much money. It's too damned much money! I know it will come back. I just need the market to come back." His eyes opened then and he asked what I was going to do about his position. I told him the truth. Our manager hadn't told me to do anything about his position. I didn't mention he had told me to call him as soon as I knew how large the position was and how bad the loss was. When Karl heard this, he repeated, "Tim, I can't lose this much money. It's too damned much money! I know it will come back. I just need the market to come back."

I felt bad for Karl. He was completely lost at this point. His sole focus was that the market was now trading at irrational levels and that if he was just patient, the market would return to rational levels and everything would be alright. He'd completely forgotten that his position greatly exceeded his limits and that his trading loss dwarfed what he was allowed to lose in several weeks, let alone a single day. How was I going to help him? What could I do to help my manager and the bank I traded for?

While Karl leaned back against the wall, an idea came to me. I told Karl to take a walk downstairs to get some more cigarettes. I told him I'd watch his position for him. I told him to quit worrying—the markets always go where they're supposed to go, right? He apparently took that to mean that I agreed with him, that the markets would return to his entry price if he only just waited it out. He said, "That's a good idea. I'm almost out of cigarettes anyway. You watch my position and I'll be back in a few minutes. It'll come back. Thanks, Tim," then he patted me on the shoulder and walked down the hallway to the elevators.

Once I saw him get in an elevator, I went to Karl's desk, checked his position size and did a quick calculation to get an idea of the size of his current loss. Then I went back into my manager's office and called him back. I told him the news was worse than he had feared—the position was more than twice what the broker had told him and the loss was nearly three times as large. In less than two hours of trading, Karl had lost more than all the traders in our trading room normally make in three months of trading!

Now my manager gave me explicit directions: go to Karl's desk and close out his position. When Karl got back from buying cigarettes, I was to ask him to come into our manager's office and call him at the home office. And while he was in the office talking with our manager, I was to double check that I had completely liquidated his positions and then check out all his trades with his brokers. Once that was done, I was to call each of them and tell them they were not to accept any further trades from Karl until they heard personally from my manager.

When Karl got back from buying cigarettes, he immediately asked me if the market had "come back to its senses." I told him that the position was doing better now and then told him our manager wanted him to call him from his office. Karl didn't flinch. He asked me to watch his position while he made the call and right before he entered the office to make the call, he said, "I'll bet it comes all the way back before I get off the phone, Tim. Give me a shout if I get in the black while I'm on the phone in here, huh?"

To this day, I don't know what my manager told Karl over the phone that day. He spent about 30 minutes in that office then walked over to his trading desk, put his suit coat on, thanked me for watching his position and then walked out of the trading room. Then, to my utter surprise, he walked back into the trading room a few moments later and opened the black binder and filled it out. Then he left for the day.

When I was done trading for the day, I, too, went over to fill out the black binder. I didn't have an overnight position, so I put zero down in that column. I'd made about \$30,000 that day trading, so I wrote that down in the correct column. And then out of curiosity, I read what Karl had written. He put down that he had lost \$90,000 for the day [which was a fraction of what he had actually lost, but that amount was within his allowable loss limit for any trading day] and he put down that he was carrying no overnight position. Our manager had apparently told him that someone had closed out his position. I shook my head in puzzlement, wondering why Karl would write down such a small loss in the black binder. Why write anything if you weren't willing to write the truth, I wondered to myself.

I got a bigger shock the next day. Karl came in the next morning with a newspaper under his arm and a fresh carton of cigarettes in his hand. He went over to his trading desk as if nothing had happened, sat down, lit a cigarette and began reading the newspaper. He spent the morning reading his newspaper, smoking, and making a few leisurely phone calls. Just after noon, he got up, walked over to my side of the desk and told me he was heading out a bit early. Then he went to the black binder and filled it out before leaving.

I had traded that day and it had been a fairly quiet day. I'd made about \$20,000, so when I was done for the day, I went to the black binder and opened it and began filling it out. After I filled in my numbers, I glanced quickly at Karl's. He hadn't written a thing down under today's date. Instead, he had erased yesterday's loss number and changed it from \$90,000 to \$122,000. It didn't make sense to me, but none of it made sense to me. Why had he come in today, and why would he change his P&L number from yesterday?

My manager was out the entire week, and each day for the rest of the week, Karl came in on time, sat and read his newspaper, and when he decided to leave for the day, he went to the black binder and revised the first day's loss to a more negative number. And then he left for the day. By the end of the week, he had revised that number to a loss of just over \$300,000. That was still a fraction of the actual loss. It was as if he could not stand to write the real loss down, could not stand to admit that he had lost the money.

What happened to Karl? He didn't get fired, actually. He was transferred the next week to the head office, where they could "watch over him more closely." He did leave the bank after the end of the year to take a job as an energy trader, so perhaps he had a term contract that ran out at the end of the year.

This event was early in my career as an institutional trader, and as time went on, I saw other traders go through what Karl went through that week. In point of fact, they could not believe that they had lost the amount of money they had lost, so they chose to ignore it, and then as time went on, they slowly came to grips with the actual loss, piece by piece, as one might get used to a new hairstyle or a new car.

Now let me tell you about a trader that worked for me briefly. The prevailing theory throughout the professional trading community at that time was that individuals who were accomplished in gaming theory generally made good traders. All of the trading managers were instructed when interviewing candidates to put a great deal of emphasis on determining if a candidate played games of strategy (chess, checkers) or played games of chance (poker or other gambling games, where they would be well versed in betting theories). We were even told to mark "inquire" if candidates visited the local horse racing tracks and liked to bet on a regular basis.

Frank was a poker player by trade, or had been before we hired him to become a trader on our currency desk. His claim to fame as a poker player was that he had made it to the finals of the World Series of Poker several years back (this was many years before ESPN became a network, so this event was fairly unknown unless you were a poker player). He interviewed well, and although he had no experience as a trader, he had a good feel for betting and odds (that's a surprise, isn't it?), and the management team decided he would make a good junior trader on my currency desk. He was to sit next to the yen trader, and after he learned the basics of currency trading, he was to be given a small position and loss limit and allowed to trade the cash Australian dollar. After serving about six or seven months as an assistant, I was told to give Frank his limits and see what he could do with the Australian dollar.

The Australian dollar market during the US daytime back then was a small market, so I gave him a 3 million Australian dollar limit and an intraday loss limit of \$20,000. And for the first five or six months, things went well for Frank. He had a few losing months, but he had more winning months than losing months and he observed his trading and loss limits. Although the Australian banks began trading at 3 pm our time, we did not have a 24-hour cash currency trading operation at the time, so by the time the larger players in the Australian dollar market were beginning to throw around large numbers and move the Australian dollar market around, our desk was closing up and balancing our positions for the day.

Our rules were simple. Everyone had intraday trading and loss limits and you never violated them. Only senior traders were allowed to hold positions overnight, and most of them preferred to go out eating and drinking with their husbands, wives, or girl or boyfriends to watching overnight positions. This was the golden age of cash foreign exchange, and if you were a good intraday trader, between your salary and your bonus, as a senior trader, you were generally paid more than you could spend.

I was on the risk committee, and also personally did all of the execution for the bank's largest clients, as well as the bank's own proprietary portfolio, so I almost always had positions to watch, and tended to get phone calls all night long from around the world as the orders I left were executed or my call levels were reached. And I tended to get into the trading room at 4 am each day—two or three hours before any of the other traders wandered in. When I arrived, the huge 350-person trading room was always pitch black and I always had to wait just inside the trading room for my eyes to adjust to the darkness before walking over to my office to hang up my coat and put down my brief case and chart case on my desk.

And then one morning, I used my key card to open the trading room door and to my amazement, there was a small pool of light out in the darkness, coming from my cash currency trading desk area. I stopped at my office and dropped off my coat, my briefcase, and my chart case. Then I headed for that lone circle of light. I couldn't imagine who had left screens on all night and I doubted the janitors knew how to turn on our built-in computer screens.

To my surprise, I found Frank on the far side of the desk, leaning back in his chair, talking to someone on the phone. I quickly paid attention to the tenor of his voice. He certainly wasn't panicking—in-fact, he seemed in quite a good mood, though his voice was a bit hoarse. He looked up at me and gave me a smile and a wink, then went right back to his conversation. I told him quietly to come see me as soon as he was off the phone and then went back to my office to check my desk for any orders that had been filled overnight and left on my teletype machine.

A few minutes later, Frank popped in smiling. "What's up, boss?" he asked. I told him I was shocked to see him here so

early, and he sheepishly told me he hadn't left last night. He'd been watching the action when the large Australian banks came in at 3 pm, got caught up in what they were doing, and before he knew it, there I was, walking in the door at 4 am!

I knew the answer to the following question was going to decide whether Frank was going to make it as a trader. "Frank, you watched all night long? Or you watched and took some positions all night long?"

"I watched, mostly," he said in his now raspy voice.

"Does that mean you traded last night?" I asked him.

"I made friends with the trader that runs the currency desk at the largest Australian bank and he told me about some huge customer orders they had, so I stayed and watched, and when I saw something that looked good, I made a trade or two." This conversation was not boding well for Frank's future. I probably didn't have to ask the next question—I thought I already knew the answer. But I asked it to give him the opportunity to answer it.

"How'd your trading go, Frank? Are you up or down?"

"I was killing 'em early on, and then after Australia went home for the night, I gave some of it back."

"How much did you give back, Frank? Are you up or down for the day—or night—or the past 24 hours?" I thought I could tell by Frank's expression, but it was important for both of us that he tell me—and tell me the truth.

"I'm up for the night, boss. I made a lot of money early." The way he said it told me something wasn't quite right. I pressed on.

"So you made lots of money early after your friend gave you a tip on some customer orders, but gave some back after the Australian traders went home for night and Europe took over, right? Do you have a position now, Frank?"

"Yeah, I have a position on. I know it's gonna come back as soon as the US comes in. My friend told me this same company has to do more this morning." Frank was fidgeting a bit now as he answered my questions. There was something still wrong here, something other than a junior trader violating the basic rule of no overnight positions.

"How much are you up, Frank?"

"I'm up \$40,000, boss." If that was true, it would be Frank's largest one-day trading gain since he began as a trader, but he wasn't acting like someone that had just made more money in one day than he ever had before.

"Is that \$40,000 including your current position priced at the market, Frank?"

"No boss. I'd have to calculate that and tell you the net P&L." Now I thought I knew what was bothering me, what hadn't come out yet.

"Frank, what's your current position?" I looked him right in the eyes as I asked this question, and by the way he dropped eye contact with me immediately, I knew he was in dire trouble.

"Uhhh...I'm long about 75 Aussie." He didn't look up as he told me his position. His current position was more than 20 times his position limit.

"And at the current market price, what's your loss on this position, including your gains from earlier, Frank?" I knew I'd be going to see the head of capital markets soon and I'd need all the facts.

Frank told me, "I'd have to go do the math, boss." I told him to go figure out his exact loss at the current market price and to write down both that and his exact position. While he went to do that, I called my boss, the head of capital markets, and filled him in. He told me to get the facts and then come see him.

I went back down to Frank's desk, still a small circle of light in the vast dark trading room, and looked over his shoulder. If I could understand what he was writing, he was long 122 million Australian dollars and at the current market price, he had net lost \$430,000. The loss wasn't a staggering amount, but it was more than 20 times his daily loss limit. And the position was 40 times his intraday position limit—but this was not during the day! He wasn't even allowed to trade overnight.

"Why are you long 122 million Aussie, Frank? Your limit is 3 million Aussie."

He looked up at me and then started to let it out: "It was going so well. Then when it turned down, I called my friend and he told me the company had lots more to buy, and as soon as the US came in, they'd start buying again. So I started adding on as it went down."

"Frank, you don't have permission to trade overnight."

"I didn't leave the trading room, so I figured it was ok. It wasn't like I was trading from home. I just stayed late and kept trading here at the trading desk."

"You're down over \$400,000 dollars, Frank. And your daily loss limit is \$20,000. Why didn't you just get out of your position when you got near your loss limit?"

Frank gave me a very odd stare, as if he was talking to an idiot, and said, "It's too big a position. I couldn't just dump over 120 million Aussie dollars once the Australian banks went home!"

I reached over Frank's shoulder and picked up the phone to one of his cash currency brokers. "Can you give me a price on 122 million Aussie, Bob?" I asked. Bob recognized my voice immediately and told me, "Sure, Tim, but it might be a bit wide." I told him I wasn't worried about the spread, I just wanted a price. Sure enough, he soon came back with a bid and offer on the entire amount and I liquidated Frank's position immediately. Then I told him to go wait in my office while I went to see my manager.

Frank had violated his position limit, his loss limit, and he had violated the rule that forbade anyone other than senior traders from holding overnight positions—which were positions when you weren't directly being supervised by a trading manager. In my eyes, Frank had badly violated all three, and I expected that before breakfast, I would be writing paperwork for his dismissal. To my surprise, my manager told me that perhaps I was judging Frank too harshly. He argued that maybe Frank didn't understand the difference between overnight positions and intraday positions. And though he agreed Frank had violated both his loss and position limits, he pointed out that the loss wasn't terribly large, given the net profitability of our trading desk on any given day. We were in disagreement and decided to see his boss to get a final opinion.

My manager's manager listened as I quickly stated the facts without giving my opinion on what to do about Frank. Then he listened as my manager in essence spoke on Frank's behalf, suggesting that he had shown some promise and maybe this was a case of just not understanding the rules fully. His manager waited until he was done and then asked the defining question: "Do either of you gentlemen want your careers decided by allowing that young man to continue to trade?" I never got a chance to answer. My manager quietly said, "We'll let him go this morning." And that was the end of Frank's career as a cash currency trader.

Finally, here's the oddest experience I had as a manager of other traders, yet in essence, it deals with the same character issue.

John was the son of a cash currency broker. Everyone knew his father, and though John was fairly young, when he applied at my currency desk for an assistant trader position, we decided to give him his chance. John started as the assistant to the yen trader and after a brief stint as an assistant was given his own small loss and position limits in the Australian dollar.

John was a natural from day one. He had spent several summers working alongside his father, so he was already well versed in how cash currencies were traded. He'd never traded before we hired him, but he knew all the mechanics. Once he got his limits, his hot streak started. He made money his first day trading. He was ecstatic. His father was proud. The other traders in the room liked him, so they were very happy for him.

He made money his second day trading.

He made money his third day trading.

By the tenth day of trading, John still hadn't had a losing day. The other traders began to comment on his winning streak. John was giddy.

Five days later, the streak was still alive. John had been trading for 15 days and still hadn't had a loser. The rest of the traders were shaking their heads, waiting for the inevitable first loss. In fact, the ones that were closest to him started warning him not to worry when that first loss came, because it was a part of trading. John wasn't giddy. John didn't know what to think.

When the streak reached 22 days without a loser, he came to see me. I told him not to worry about it—take the trades and very soon, one would be a loser. But it's just a part of trading. Winning streaks happen, losing streaks happen, but as long as you keep them in proportion, they're just a part of trading. John was very nervous about all this.

He didn't make a trade the next day. Or the next.

A group of traders took him out for a few beers after work and came up with a plan. They'd *help* him make a losing trade, to "get the monkey off his back." Then he could relax and just trade once the streak was broken.

I honestly believe he tried to lose money the next day. But he didn't. He took a position that the traders in the room were certain was a clear loser, and it was a nice winner before he could blink his eyes. He wasn't happy. He wasn't mad. He was frozen.

When he came in the next day, he just sat there. I watched the other traders try to talk to him, try to draw him out. After watching him sit in agony for several hours, I called him into my office. "A loss is just a part of trading," I told him. He shook his head and then sat there quietly.

"John, sooner or later, you'll have a loser and then you won't feel all this pressure. You can just go back to trading, and start again like you did the first day I gave you limits."

John shook his head and said glumly, "You don't understand. I'm on a streak. If I break this winning streak, I may never have a winning trade again."

Try as I might, I couldn't get him to think about it rationally. I flipped coins for him for over an hour, at one point flipping heads twelve times in a row, and then a bit later, flipping tails nine times in a row. I was trying to show him that even in a random string of events, positive and negative runs happen, but over the long haul, they are just a part of the entire

results. He listened, but he wasn't buying it.

He came in the next day and talked about trading. But he didn't make a trade that day, nor did he make a trade the following day. When some of the traders tried to help him make a trade, he wasn't interested. When I explained to him in private that traders trade and trading meant winning and losing, he didn't say a thing. He was frozen. As surely as traders that are caught with losses well past their limits are frozen, John was frozen.

Monday, John didn't come in. He didn't come in on Tuesday, either. I called his father. His father knew about the streak but didn't know John hadn't shown up for work the past two days. He told me he'd find him and have him call me or show up for work the next day.

And around mid-morning the following day, John walked in and headed straight for my office. I left the trading desk and went in and closed the door. He didn't say a thing, just handed me a letter of resignation. I told him he'd shown good promise as a trader and asked him if he was certain he wanted to resign. He told me he'd made up his mind to go be a broker. He didn't like the feeling of going through streaks. I asked him if he wanted to talk with any of the other traders before he finalized his resignation and he told me he'd rather just leave so he didn't have to answer questions. He had made his mind up and just wanted to be done with it. I took his letter of resignation and shook his hand and he quietly turned and left.

These three traders were all successful at one point in their trading career. But all three were unable to master the hardest part of trading: their own weaknesses. This applies to professional traders and to those of us that trade our own money. This is about being human. You can be able to make money hand over fist when times are good, but if you cannot master your self when times are bad, you will find being a successful trader nearly impossible.

"Master your tools, Master Your Self." ®

I wish you all good trading.

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