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THE CONTINUING EDUCATION OF

Active TRADER Interview

In early 1997, Victor Niederhoffer had a best-selling book and a top-rated hedge fund with more than $100 million under management. By October that year his fund and reputation were in tatters. Nearly six years later, he talks about market mumbo jumbo, crawling back up the stairs and the triumph of optimism in the stock market.

"I can't make any money!"

Victor Niederhoffer's voice reaches a mild crescendo as he talks about his trading since the highly publicized collapse of his hedge fund in 1997. He's being pressed (gently) to provide some details about his trading methods, and his response seems part diversion (he's not giving away any goodies for free!), part humor and part humility.

The truth is that Niederhoffer *is* making money, trading what he describes as a "small hedge fund." Although he has been much less in the spotlight in recent years, he has, in fact, been trading since July 1998 — roughly nine months after his fund shut down in 1997.

He's also been a busy financial columnist, along with his co-writer and trading partner Laurel Kenner. The pair currently writes a column for CNBC Money, and they have provided similar services at TheStreet.com and WorldlyInvestor.com. (Previously, Kenner briefly wrote a column for Bloomberg LP.) They have archived and expanded much of this material on their Web site, Daily Speculations (www.dailyspeculations.com).

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A SPECULATOR

BY MARK ETZKORN

"If there's one idea people should get from this interview, it's that when anyone proposes an idea, a phenomenon, a regularity, or a recommended action, they should always ask, 'Er, have you tested this?'"

— Victor Niederhoffer

Niederhoffer's post-1997 trading, research and writing career is chronicled in a new book he and Kenner have written, *Practical Speculation*, which energetically assaults various accepted market principles while championing optimism and the application of the scientific method in trading (see the accompanying review, p. 76).

Niederhoffer, 58, has earned a measure of notoriety rare in the hedge-fund world. He has quite a pedigree: an academic career that encompassed Harvard, the University of Chicago and Berkeley; and a professional career in which he has traded for none other than George Soros, and in turn helped launch the careers of such highly successful traders and hedge-fund managers as his younger brother Roy Niederhoffer, Monroe Trout and Toby Crabel.

So when Niederhoffer says, "I can't make any money," it becomes apparent he's really underscoring a few simple points: He still takes risks, he still has setbacks and he doesn't want to get too cocky.

In 1997, competitiveness and cockiness came together at precisely the wrong moment, as Niederhoffer — who at the time had been ranked as one of the top hedge-fund managers for nearly two decades and was determined to remain so — refused to relinquish a long position in the Thai stock market as that country's currency collapsed and triggered a meltdown in Asian financial markets.

He might have survived this setback, but the Asian debacle eventually reverberated in the U.S. market, culminating in a 554-point plunge in the Dow on Oct. 27. Exchange "circuit breakers" shut down the market early and left Niederhoffer unable to extricate himself from a huge short put position. He got a $50 million margin call and was forced to close his fund.

Ironically, in December 1996, Niederhoffer had published his first book, the autobiographical *The Education of a Speculator*, which included ruminations on everything from sex and Shakespeare to music, squash (the game, not the vegetable) and horse racing. The book, which Niederhoffer describes as "a love story about my father," received enthusiastic reviews, although Niederhoffer was occasionally chided for being somewhat esoteric and self-aggrandizing.

To add insult to injury, if he was given the benefit of the doubt on these points when the book was first published because of his superior trading record (he was fresh off another year as the top hedge fund manager in 1996, and was managing approximately $130 million), the goodwill vanished after his fund collapsed. The combination of high-profile book and financial woe made a great story — a parable of a self-congratulatory trader's ego resulting in his downfall: "Look, he writes a book called *The Education of a Speculator*, and he blows out a few months later."

Niederhoffer became something of a bogeyman in the financial press — a name invoked to warn of the risks of overconfidence and foregoing such trading basics as using stop-loss orders. In an industry saturated by competitiveness, and with more than its fair share of ego and envy, he was an irresistible target, and few pundits passed up the opportunity to take a shot at him.

In private, Niederhoffer was devastated, both personally and financially. Many of his clients had become more than clients over the years, he says, and the pain of losing his friends' money and seeing longstanding relationships dissolve compounded his personal financial losses and public embarrassment. Among other responsibilities, he had six daughters to care for, and he found himself in the unavoidable position of having to sell off many of his assets to stay afloat.

Since then, he has been "trying to crawl back up the stairs," as he says. In *Practical Speculation*, he writes that many people with whom he had done business in the past would no longer work with him, and he was unable to establish the kind of trading operation to which he was accustomed.

Around the same time, Laurel Kenner was coming to a crossroads of her own as a financial writer and editor. In 1998, she was chief stock market editor for North American stock markets at Bloomberg. But she had developed misgivings about the way the markets were covered; unfortunately, she had no idea how to change things. Then she came across Victor Niederhoffer, who had no shortage of opinions.

In late February, Niederhoffer and Kenner discussed with *Active Trader* their work together as columnists, the ideas in their new book and the never-ending challenges of trading.

AT: *How did you two start working together?*

LK: We met while I was at Bloomberg. I found that Victor had a lot of ideas about how stock market coverage could be improved. We eventually decided we could do a better job and started to write columns together in January 2001.

Basically, we came to the conclusion that a computer could be programmed to write stock market coverage the way it was being done. All stock market stories follow a simple formula: Stocks are up on earnings optimism or interest-rate optimism, or down on earnings pessimism or interest-rate pessimism.

Of course, that's not what's really going on in the market at all. If you actually act on that [formula], it's a losing trade.

AT: *When did you start to have misgivings about typical market reporting and financial journalism?*

LK: In 1998, my reporters started telling me that we were the laughingstock of Wall Street. They'd call someone to get a quote to fill in the market story formula, and the quote was supposed to explain the market action of the day in one or two sentences. Our smarter sources — traders — thought this was just hilarious.

The institutional guys would use us to puff their stocks or their funds: "We sold our shares of XYZ" — whatever was bombing that day — "in recent weeks." Bloomberg prized these "big money" quotes above all. The more money the source managed, the better.

The nadir came when our coverage was satirized in a book. The author, who was kind enough not to name Bloomberg, reprinted the "real-time" market stories we put out in one day and noted how we switched from optimism to pessimism in seconds, each time citing a bogus reason — the economy, interest rates, earnings.

I tried to change this, but the powers that be liked it the way it was. Until Vic took me under his wing, I didn't really know *how* to fix it. When I finally started to figure it out, my bosses decided they wanted to do it their way.

VN: As we write in the book, Laurel was the main progenitor at her firm for these destructive "memes" — repeating *ad infinitum* untrue proverbs that would always get the public on the wrong foot.

We'd had some contact, and she was in the process of writing her own column for the first time. And the ideas, a lot of them based upon my contributions, were startling to the infrastructure at her publication. There were references to things like baseball and Moby Dick, as well as testing trading ideas to see if they worked, and naturally someone said, "That's not us. We're not in the business of testing whether something is true."

AT: *When you started your co-written column was there any goal other than to discuss market ideas in more scientific terms?*

LK: That was one goal, but there's another aspect to what we did. There's a book by Friedrich Hayek called *The Fatal Conceit*, which talks about how a market is composed of countless people making decisions based on what's valuable for *them*. We felt our readers had more wisdom than a dozen stock-market gurus of the kind you see quoted every day.

So we opened up things to our readers and, in doing so, we assembled an amazing group of scientists, philosophers, traders and hedge-fund managers — the number is now up to around 200 — with whom we communicated by e-mail every day. Our writing and reporting has benefited immeasurably from it.

VN: It was also our goal to relate the markets to other unfathomable phenomena, like music, sports, games and biology.

AT: *Do those kinds of comparisons have practical trading*

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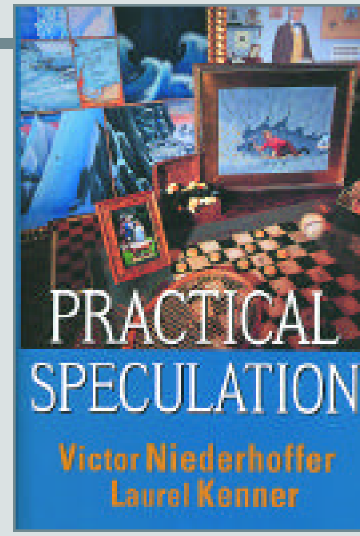
"All stock market stories follow a simple formula: Stocks are up on earnings optimism or interest-rate optimism, or down on earnings pessimism or interest-rate pessimism. Of course, that's not what's really going on in the market at all."

— Laurel Kenner

Book review

Practical Speculation

By Victor Niederhoffer and
Laurel Kenner
2003, John Wiley & Sons
398 pp., hardcover
$29.95



In *Practical Speculation*, hedge-fund manager Victor Niederhoffer and financial writer Laurel Kenner blend statistical analysis and personal experience — with insights drawn from everything from baseball to the physical sciences — to create the best trading book of the young millennium.

Readers of Niederhoffer's 1996 book, *The Education of a Speculator* (as well as Niederhoffer and Kenner's online market columns), will be used to this eclectic blend of subject matter, which delights some and leaves others running for the exits. However, *Practical Speculation* spends considerably more time crunching numbers and addressing details than the autobiographical *The Education of a Speculator*. In between more *haute* literary and cultural asides than a season's-worth of "The Dennis Miller Show" (and a few song parodies), the authors slaughter an assortment of sacred market cows and explore the possibilities of a number of statistically based trading concepts.

The book opens with an account of Niederhoffer's sobering experience after his 1997 hedge-fund close-out, and details his subsequent pairing with Kenner and their careers as challenging and sometimes subversive financial columnists. After documenting the uninformed, pessimistic malady they feel has the market in its grip, the authors get down to attacking the problem at its roots.

The book's two major sections, "Mumbo Jumbo and Moonshine" and "Practical Speculation," represent condition and cure — the condition being the prevalence of untested, anecdotal or fraudulent market concepts and trading ideas, and the cure consisting of application of the scientific method (gathering facts, discovering regularities and patterns, forming theories and testing predictions) to questions of market behavior and trade strategy.

In short, the authors' mantra is test, test, test (or, if you like, statistics, statistics, statistics). They reject subjective tools (such as certain vaguely defined price patterns) on the grounds such approaches cannot be statistically validated. They also show that when certain pieces of accepted market wisdom are subjected to testing, they produce results far different from their popular reputations.

A nearly militant quant, Niederhoffer demands not just that an idea be tested, but that the results are reported in terms of their level of statistical certainty. Fortunately, the book offers solid ideas about testing, as well as how to determine whether the results are reliable. Chapter 8 ("How to Avoid Spurious Correlations") specifically discusses the ways we can be fooled into thinking that something random isn't — a scenario familiar to any trader who gets positive results in testing only to watch a strategy implode in actual trading.

Departure points for many of the authors' arguments are their critical dissections of numerous market myths, fallacies and shared hallucinations. Their first target is earnings, and their debunking of the widely accepted relationship between earnings and future returns is a genuine public service. Other targets include technical analysis, chronic bears and value investing. It's unfortunate that Niederhoffer's failure in 1997 will make it easier for Wall Street to dismiss the criticisms he and Kenner level at it. They raise serious issues and rarely take aim at a target without arming themselves with plenty of data.

In hunting their prey, however, Niederhoffer and Kenner sometimes wield a shotgun rather than a rifle. A shotgun leaves more room for error — you're more likely to catch at least some of your target than if you were using a rifle, but it's also a little messy and sometimes you hit things you shouldn't. Just a handful of the targets who catch some buckshot — a few more randomly than others — include Fed chairman Alan Greenspan, Warren Buffet, Jack Schwager, Martin Schwartz, Richard Arms, Alan Abelson, *The Wall Street Journal*, Tom DeMark, *Active Trader* and Japan.

Without commenting on this list one way or the other, while many of Niederhoffer's and Kenner's criticisms hit the bull's eye, others just catch the periphery, and occasionally they miss the target altogether.

> "[In] no field has such little advancement of knowledge been attained as in stock investing during the past century. [T]he continual use of dubious methods and data, the avoidance of testing, the reliance on authority, the cultish reverence paid to celebrity investors, the pronouncements of selective gurus, and the attempts to mislead with propaganda, are far more widespread than in any other field."
>
> -- *Practical Speculation, page 218*

One minor example is singling out analyst Tom DeMark's quote, "The trend is your friend unless it's about to end," in the chapter that attacks the vagaries of technical analysis, in general, and trend-following, in particular. However, DeMark is not a proponent of trend following; his quote was ironic and meant to highlight the inherent difficulties of trying to mechanically follow trends. Like Niederhoffer, he is primarily a contrarian

Similarly, the authors ridicule what is depicted as ambiguous, subjective trading advice from one of Jack Schwager's *Market Wizards* books. Later in the same chapter the authors report the results of tests showing the poor performance of several candlestick patterns. It's unfortunate Schwager is not recognized for having published in his 1996 book *Schwager on Futures: Technical Analysis* similar candlestick tests that produced similar results.

A more significant example is the authors' wholesale dismissal of technical analysis through dissection of only a handful of methods (and focusing mostly on trend-following). Most of their arguments regarding the harmful effects of subjectivity and the lack of evidence supporting the value of many popular technical ideas and tools are absolutely correct. However, their narrow definition of "technical" excludes many techniques — including those advocated by the authors — that are commonly considered technical analysis, including quantifiable price relationships many traders describe as patterns.

The criticisms sometime come off as a little too mean-spirited, or lacking in perspective or balance (as in the Schwager example). Niederhoffer and Kenner talk a great deal about propaganda in the trading industry, but more than once they come very close to using the tactics they decry in others.

Regardless, a little less (or a little more focused) vitriol would have distracted less from the book's truly fruitful research and statistics, unique market concepts and great trading insights. The financial industry has more than its share of snake-oil salesmen and misguided gurus (it will 100 years from now, too). I would have happily read a book devoted exclusively to excoriating these types. But a book devoted solely to discussing market and trading ideas would have been nice, too. (But honestly, the criticisms are fun to read, regardless of whether you agree with them.)

In the second half of the book, the authors argue on behalf of the ultimate power of the long-term upward bias of the stock market, suggest ways to improve on buy and hold, and present evidence showing the superiority of growth stocks over value stocks and the correlation between baseball and the market, among other topics. Chapter 14, "Practical Market Lessons from the Tennis Court," draws parallels between Niederhoffer's beloved racquet sports and trading. This chapter alone contains enough tantalizing trading insights and market relationships to keep an inquisitive researcher busy for months.

The authors illustrate many of the issues they discuss — especially the problem of adjusting to ever-changing market cycles — in a chapter that chronicles the failed application of well-researched trading system based on insider trading patterns in biotech stocks. Another unique chapter offers ideas for judging the merit of a company's balance sheet — things people can do to guard against the now well-documented habit of corporations to fudge their numbers right and left.

The book jumps from idea to idea, and may put off those who don't want to read references to Greek tragedy, Gilbert and Sullivan and chess openings in a "trading book." Niederhoffer and Kenner can be accused of pretension, but not of laziness. In writing a book that attempts to discuss trading from such a unique perspective — philosophically and culturally as well as statistically — the authors set a very high bar for themselves (and for the reader). In doing so they invite criticism on an equally high level. This is a compliment; the majority of trading books do not merit such serious attention and discussion.

Some people will reflexively dismiss a trading book co-written by a man who publicly lost millions of dollars. Others may find the book's approach too non-linear or its tone too abrasive. But they'd be missing out. Despite its glitches, *Practical Speculation* offers more trading "truth" than a dozen typical market books combined. It's in a league of its own.

— Mark Etzkorn

value, or is it more that they illuminate certain market concepts?

VN: Most of our ideas lead to testable hypotheses, but we're very careful to be humble about our knowledge of qualitative phenomena.

You see, the big problem is that almost everything the public is taught about the market — by virtue of an invisible, evil hand — turns out to be designed to make the public make the contribution necessary for the market's massive overhead.

It was inevitable that someone like (value investing guru) Benjamin Graham would be considered the irrevocable, No. 1 hero of the market. There's probably no one more revered in the investment firmament than Benjamin Graham, or (*Barron's* columnist) Alan Abelson. And one will make the public do more wrong things than the other.

The leading financial newspaper has had as its main columnist over the past 40 years someone who has never once issued a bullish pronouncement. During that time the market has gone from Dow 500 to Dow 10,000. Think of the incalculable loss of wealth the public has been subjected to because the most powerful and probably one of the most intelligent [financial writers] in control of the most influential financial publication has been unrelentingly cynical about the market.

AT: *What do you suggest people do to avoid this trap, as you see it?*

VN: If there's one idea people should get from this interview, it's that when anyone proposes an idea, a phenomenon, a regularity or a recommended action, they should always ask, "Er, have you tested this?" If they did, they would find 99.99 percent of what they use in their normal market decision-making is untested.

Testing is just the beginning, though. Once you've tested, you run into the problem of rational expectations and ever-changing cycles, uncertainty and variability.

If a market phenomenon is important enough to be of interest, then some method of testing should be used, and that method should involve a measure of uncertainty, as well as a norm for

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"As soon as something is very probable and widely known, the payoff and the chance of success are reduced."

— Victor Niederhoffer

deciding the level of uncertainty that determines whether to accept or reject the phenomenon.

AT: *So, even if you have positive test results for a particular trading idea, you then need a way to determine the likelihood those results are reliable or meaningful, rather than the product of chance?*

VN: Yes. When you test something, the first thing you do is report the average results. But that's only part of the story. The average has a certain uncertainty attached to it — a width around the average created by normal variations in the sample. That uncertainty is usually called a confidence interval. That's the thing that should be paramount in people's minds.

"Er, have you tested this?" is the simple question that's gotten us into so much trouble. One of the problems with our book is that we don't admire the conventional wisdom — the pap and the promoters — on Wall Street. We don't think a person can make money following [Warren] Buffet's ideas, or the trend-following idea, unless it's tested. And those guys do not test. They rely on anecdotes and remembered myths of great heroes who may or may not have gone bankrupt two or three times.

Have you ever looked at a [horse] racing magazine? None of the racing magazines will tout a system unless they have a workout (historical test statistics). [*Active Trader*] is pretty good about including workouts of the different ideas. The readers in your camp are two steps inside the door — they at least know a workout and a test is required. Unfortunately, though, most of the tests don't contain measures of uncertainty.

AT: *What's a good measure of uncertainty?*

VN: There's a rule of thumb in statistics: Report how probable the results are to be different from chance, then provide a confidence interval regarding how wide the range is that the average would stay between it 95-percent of the time.

To put it in much simpler terms, a good thing to do is calculate the average absolute deviation. Anyone can do it in a minute. Say you have a typical trading system that buys on a breakout, and the results show five trades with profits and losses of +5, +3, +1, -3, and -5. The mean of those results is close to zero (.20). If you add the absolute values of each of those five numbers you get 17, which is the total absolute variation about the mean. The average absolute variation is 17 divided by 5, which is around 3 (3.4). That's a very good measure of uncertainty. If you multiply the average absolute variation by 1.4, it turns out to be a good estimate of the standard deviation.

But then you run into the problem we love to talk about — ever-changing cycles. You know, a lot of out-of-sample test results don't work as well as the in-sample results — things often work much better in the test tube than they do in the human body, so to speak. Robert Bacon (author of *Secrets of Professional Turf Betting*, a book on horse-race wagering) had a great insight in the 1940s: If a system is well-known, then people start betting heavily on it and the payoffs start getting reduced.

Even more importantly — and this is one of the most brilliant insights in all of speculation — Bacon points out this would be true even if the results *didn't* change, even if the horses still ran at the same rate and had the same winning percentages. But then he points out the results *do* change, because the owners tell their [jockeys], "You know, if you get him out on the back stretch and he's not clearly in the lead, don't push him too hard." As a result, horses that used to be 5-to-1 shots and won 30 percent of the time are now 2-to-1 shots and win only 5 percent of the time — the jockeys don't push them too hard because the owners don't want to bet on their horses when there are small odds on them.

The same thing happens in the market: As soon as something is very probable and widely known, the payoff and the chance of success are reduced. And this does not even take into account the uncertainty issue we discussed before.

So whenever people are presented with a trading idea, they should ask whether it's been tested, then take uncertainty into account, and finally, be very careful that what they're being spoon fed is not going to destroy them.

AT: *Given all these obstacles, you make it sound virtually impossible to find and trade a worthwhile idea or system. How many of your initial market observations or concepts end up actually being traded in the market?*

VN: A tradable idea is very rare, unfortunately. Things are much easier on paper than they are in the real world. People should be very humble about thinking a specific system is going to make money in the real world. They should also be very [careful] about buying systems, and the promoters of systems should be very humble about selling them without many, many caveats.

But more importantly, if you have 100 systems, it's approximately 99 percent likely one of them will show — in the sample — a result that appears to be profitable by chance.

In other words, there are people all over the world testing various relationships — thousands of them — and by chance, a few of them are going to look like they actually make money. But [this appearance of profitability] is just a random phenomenon, and the future results will be random — except if everybody is following it, in which case the results will be much *less* than random because the payoffs will be reduced.

The same way the odds change the results in horse racing is true in the markets, because there are a lot of smart guys who implicitly know about all the systems: They know where all the stops and trigger points are, and they take advantage of it.

You can't be slow-moving in the markets. You have to be very flexible and have a dynamic persona. There's no such thing as a free lunch.

AT: ***What kinds of popularly accepted ideas did you find didn't stand up under scrutiny?***

VN: The first thing we talked about was earnings propaganda. The main idea that has the market in its grip right now is that you can, for example, compare a price level today with a past price level and, if the levels are similar and the reaction in the past was, say, negative, it's likely the current reaction will be negative. That's the idea in it's most general form.

For example, the dogmatists like Robert Shiller (author of the book *Irrational Exuberance*, Abelson, (short seller) William Fleckenstein, Buffet and Greenspan hold that price-earnings ratios were, for example, 25 in 1929, and now they're 25 again; and dividend yields were half a percent then and now they are again. The market went down in 1929, and therefore the market is likely to go down in 2003.

There are a lot of things wrong with this idea. One robin does not create a spring. You need to at least ask, "Were there other points when price-earnings ratios were high but the market went up?"

Demand and supply for an asset do not relate to past prices and past historical expectations; they relate to *future* expected costs and desires. This is an elementary economic principle in every standard freshman economics class.

What's happened in the past, if it's discounted or anticipated, has no impact on what's going to happen in the future. If everyone believes the market is too low or too high because prices are relatively low or high for whatever reason — then it's already been anticipated and it has no impact.

The most basic thing about the market that people used to be taught and used to realize is that the market works on anticipations and expectations rather than past realizations.

AT: ***Anticipation and expectation alone would seem to reduce trading entirely to subjective prognostication. Isn't analysis of past relationships the only way to start understanding current relationships — as long as you remember you need to adjust your conclusions for changing cycles, current market characteristics and so on? Isn't the fact that you advocate testing evidence of the need to rely on past information, despite its limitations?***

VN: The systematic examination of how and when expectations are inaccurate is a great subject. A good way to quantify this is *vis-à-vis* whether the time of events is known and the magnitude is not, or when both time and magnitude are under question.

Another classification that's helpful is based on whether the news and market action refutes or confirms an accepted hypothesis. If the former, major changes can occur as new paradigms take place. The rumor and the news are another classification.

Attempts to quantify all these would do much better than all the mumbo jumbo about behavioral finance, ad hoc grounding and regret theories, whether Nobel prizes are given for them or not.

Now, the third major thing that's wrong with the comparison reasoning we were discussing is that the relationships have changed. There's a big difference between the current demand for an object and the demand for it in 1929. In other words, when you say price is low and so the quantity demanded will be higher, you're talking about a current demand curve based upon expected future prices. But you're certainly not comparing the quantity demanded in 2003, relative to a price, to the quantity demanded in 1929.

For one thing, the public ownership of stocks is approximately 20 times higher today and the percentage of issues that mutual funds are allocated is twice as high. The amount of buy-backs is higher than the amount of dividends, and so on. Finally, there's the principle of ever-changing cycles.

But even assuming there really was a relationship between P/E ratios and future returns — which is an important assumption, because not only is it intrinsic to the bearish axis that has the world in its grip right now, but it was what caused Dr. Greenspan to issue his famous "irrational exuberance" warning — no one ever tested it! Well, we did, and recorded the results in Chapter 2. Not that our test is definitive, but at least we tried. We looked at the price-earnings data for a certain year, then looked at the return the next year — and we found a slightly negative correlation.

[The nay-saying axis] might say, "Well, we don't have to test this because there are certain heroes whose legendary advice has always been to buy low P/E stocks or value stocks, or to follow the trends." Some of those "heroes" might have a lot of accolades, some might have made money, some might not have made money, some own sports teams and some don't…

It's true that if you look at 10-year data samples and you leave out the 1990s, you might have five or six observations that have some anecdotal interest. But these days a month is a lifetime in the market, let alone a year! The idea that, even if the first four problems didn't exist, someone would recommend an investment approach based upon this untested P/E relation is a tragedy. In our book, we liken it to cult behavior.

AT: ***In your book you reference research from the book*** **Triumph of the Optimists** ***showing, among other things, the massive returns produced by stocks in the last century. That doesn't negate the reality of dealing with bear markets, such as the one we're in, does it?***

VN: All the talk about bear markets and bull markets is mumbo jumbo. There's no such thing as a bear market or a bull market — except if you define it in terms of the previous price change. In other words, there's nothing intrinsically more bearish about the future now than in the 1980s or the 1950s. Believe me, there was quite as much negativity about the market in the

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1980s after the real return was around -90 percent in the 1970s.

Yes, you *can* define a market in terms of the previous move. That's something that's measurable and can be a good benchmark. If you look at what happens to the market in the future after it has gone down in the previous *x* months or *y* years, you find a slightly inverse correlation between the move in the previous period and the subsequent period.

If you believe that because the market has gone down it's more likely to continue going down, then you're more likely to give credence to the bearish axis.

As an example, our editor, Jon Markman, wrote an article about Didier Sornette's book (*Why Stock Markets Crash: Critical Events in Complex Financial Systems*), in which the author predicted a cataclysmic [crash along the lines of] Prechter's fatal crash scenario. Instead of using Fibonacci numbers and Elliott Wave, though, he applied an earthquake-prediction method based on Fourier analysis to predict when the next crash would be.

Markman got 500 responses — around 100 times the normal response — from readers all over the world who were very concerned about the decimation of their own financial portfolios and their changed retirement, marriage and child-rearing plans. Anyone who writes about the bearish idea strikes a very resonant chord.

It's not so much that we're always bullish — there was a tremendous amount of excess in the run-up of certain Internet stocks and biotech stocks, for example, in the late 1990s — but it's important to know that the average stock in any country in the world went up a million and a half percent in the last century. Ten years from now, the prime movers and believers in the bearish axis are going to be shaking their heads in disbelief, wondering, "How in hell could I have missed this tremendous run up?"

There have been conditions in the last 100 years that were much, much worse than today: in 1907, when interest rates reached 100 percent; during World War I, the market was closed for six months because things were so bad — no one knew who was going to win the war. Then there was World War II, Vietnam, and the 1980s, when long-term interest rates were 18 percent. There's always a reason to be negative.

So that chapter on the Dimson, Marsh and Staunton (authors of the book *Triumph of the Optimists*) findings is very important. The fact that stocks have an undeniable upward bias and such a favorable long-term return is something people should have in the back of their minds and it should override the flimsy ephemera they're exposed to.

AT: *If you take this perspective at face value, it sounds like an argument for the most literal kind of buy-and-hold approach. Can't this perspective be a foundation for extremely long-term investments, while you also realize there are certain realities, such as how long people's investment lives are, when they'll need money and how they can invest, that make it practical to also think about alternatives to buy and hold — short-selling strategies, and shorter-term strategies?*

VN: We talk about alternatives to buy and hold. I think this book is much better than *The Education of a Speculator* from the perspective of providing specific trading ideas. If you look at the [online bookstore] reviews for my first book, many people are very disappointed because I didn't tell them how to make money. The reason I didn't tell them is I don't know how to make money myself!

My disaster in 1997 is just one instance. I'm always losing money and my best systems are always changing. I have a tremendous research staff and I very actively research all sorts of things. But the truth is there is no simple way to make money.

LK: We test numerous trading ideas. For the chapter on how to tell good companies from imposters, we looked at elements of the balance sheet that aren't often considered. We found some very interesting relationships to future performance. For example, if accounts receivable are increasing as a percentage of assets, beware.

VN: And we also discuss how to use Value Line, and improve upon the Value Line timeliness actions — when they work, what months of the year the work, what price levels they work at.

I think we also included a pretty definitive test of whether value beats growth. As a defensive measure in the 1970s, Value Line said, "Hey, we have to come up with something better than following the earnings surprises and the earning revisions." They noticed there were a lot of academic papers with data from the 1930s and 1950s that showed if you bought the low price-to-book and the low price-to-sales companies, you performed 10 times better than the average stock. The study by Fama and French was the most famous of these.

So Value Line decided to give this information to their readers every week. Every week they've been presenting, on a prospective basis, from their 1,500-stock universe, the companies in the best-value group — low P/B, low P/S and low P/E. They re-balanced every month and reported the results, and they found that after around 30 years the growth companies performed about a hundred times better than the value companies.

You might ask why other people don't find that same result. We attribute it to the fact that they're using epicyclical databases that have tremendous survivor bias.

AT: *What does "survivor bias" mean?*

VN: The problem with such "good value" companies is that a lot of them go bankrupt. They're such good values, their prices are so low relative to their book values, that eventually the price goes to zero and they get liquidated. That's what Warren Buffet found. He used to be a value man, too. But Charlie Munger finally said to him, "Warren, we keep buying these short-line ag-equipment companies when the PPI has gone up by 50 percent the previous year, or we're buying retail candy stores or manufacturers of old-fashioned textile equipment, and then we can't sell them." And that's why Buffett started buying brand-name "untouchables" like Coke and Gillette.

Compustat, the computerized database that's most often used for academic studies, doesn't include the companies that were "great values" but went bankrupt. So the data has a bias toward the companies that survived. Nor do these data files include the companies that were very small at one time but became great growth companies. So there's actually two kinds of bias. A lot of the studies that use these computerized files

"The most basic thing about the market that people used to be taught and used to realize is that the market works on anticipations and expectations rather than past realizations."

— Victor Niederhoffer

are, therefore, highly flawed.

Another problem is that many of these studies rely on data from 20 years ago! As an example, in a recent article we reported on a major academic study of IPOs that was published in 2000 as a "current study," but used data from 1982 to 1987. Also, it covered only the one-seventh of the companies that went public for which it could find continuous data.

The significance of that Value Line study is that its based on the weekly data they collected over 30 years. That's very different from the typical "What Works in the Market" kind of study.

AT: *Right now I have the book open to the beginning of the "Practical Speculation" section. You start out talking about the importance of defense, using a chess analogy.*

VN: Always move pawn to G3 and bishop to G2 — that's much better than attacking the center. The goal is to attack something indirectly but you also defend. [Chess grand-master] David Bronstein's major point was that if people would stop going right at the center of the board and creating a clash at the outset, and instead get their king to safety by putting their bishop on G2 and covering the long diagonal in the center of the board, then they'd play a better game and not lose so quickly to better players.

By the way, I'm not a really good chess player — I'm a good checkers player. I have a big chess library and I can talk a better game than I can play. But Bronstein definitively states that defending your king has to be your first priority. Move your bishop out, castle, keep your pawns there and you have a kind of triple defense.

That's a very good thing for the public to do in the stock market: Protect themselves from the big disaster. I wish I had taken my own advice.

AT: *On that subject, you took a lot of shots from people who said, "Well, here's a guy who didn't put much emphasis on risk control, and look what happened."*

VN: I *did* talk about risk control in *The Education of a Speculator*, but unfortunately I wasn't wise enough or smart enough to implement [my own ideas].

When I wrote the book I was the No. 1 [hedge-fund manager] for the past 20 years or so. I was winning award after award, and unfortunately, I believed some of the hype people we're saying about me.

I made some mistakes, and the main thing I'm sorry about is the investors who lost money with me. Many of them based their decision on their evaluation of me as a person, and a lot of them were my very good friends. Many of them had been clients a long time and I had made a tremendous amount of money for them.

I always told people not to put more than a few percent of their wealth with me, and I told them it was very risky — that I didn't know how to make money without taking risk. But I took too much risk.

But the main problem I had was that I got caught in an illiquid market, and that sort of created a titanic cascade of problems that eventually put me in an indefensible position when they closed the market that fateful day, Oct. 27.

AT: *Did you really feel compelled to take larger risks because you wanted to stay No. 1?*

VN: Well, I was upset when we were No. 2. There was a Canadian fund who used to run neck and neck with us for No. 1 in 1995 and 1996. We'd make, say, 60 percent and they'd make 90 percent. They had one of these "recovery funds" that didn't have to pay management fees.

But I'd get very upset when they were ahead of us, and that was a failing in me. I was very competitive; I wanted to be No. 1. But at least I've learned my lesson. I'm never going to try to be No. 1 again. I'll be very happy if I'm in the top quarter.

AT: *You're trading again now, correct? When did you start up again?*

VN: Yes, I'm trading again. I sold some [mortgages and busi-

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nesses that I owned] and paid off some debts that I had, and I'm trying to crawl back up the stairs. Should I be ashamed of that?

I started trading again around nine months after my fund closed — I had to. By the way, I paid all my debts. I've been in business for 40 years and I've never had a suit against me.

I'm deeply regretful I caused my investors to lose money, but I lost a tremendous amount more than they did. I basically lost tens of millions of dollars in that — I was the biggest investor.

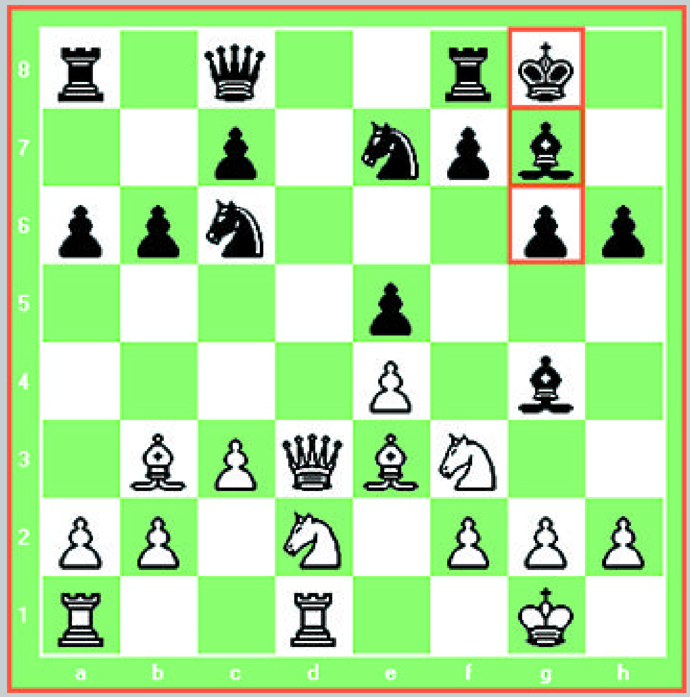
Alright, I failed. I have six daughters and I'm trying to make a living. I can't serve as a squash coach anymore — they ended the hardball game of squash. *(Niederhoffer is a former squash champion. He used to play the North American game of hard ball squash, which has been supplanted by the European version, which uses a soft ball.)* So I had to get a job as trader again, and I have a little hedge fund.

AT: *So how are things going? What's different from six or seven years ago?*

VN: I'm trying to apply the same lessons that are in *Practical Speculation*. Believe me, I'm paying a lot more attention to the Bronstein opening than I am to pawn to king four. I'm trying to defend the king and I'm not trying to be No. 1.

I still don't have the secret; I'm still subjective. I was short puts on Sept. 11, and in the middle of last year, and I lost a lot of money.

"Bronstein's major point was if people would [quickly] get their king to safety by moving pawn to [G6] and bishop to [G7], they'd play a better game. Defending your king has to be your first priority. That's a very good thing for the public to do in the stock market: Protect themselves from the big disaster."



AT: *What has your performance been like?*

VN: Let's just say I'm crawling up the stairs and I'm a much humbler and more contrite person. But I'm way ahead of the market, since I started.

I didn't bring the subject up because I would never recommend someone invest in my hedge fund again, because I still don't know how to make money without tremendous risk. But I'm way ahead of the market.

AT: *You seem to talk more about losing than winning, even in the book. How about discussing a representative trade that worked out?*

VN: As far as I know, I have never had a trade that worked out satisfactorily — I'm never satisfied. If it's good, I didn't put enough money on it. If it's bad, I shouldn't have put a cent on it. Regrettably, the bad is much more vivid than the good — I don't remember any of the good.

It's the same way in squash. I remember every defeat and was always afraid the next was around the corner. I spent too much time trying to be number one before 1997. Now, I'm just happy to climb up the stairs one at a time, knowing that I will fall almost all the way down again on the path up.

Next month: Victor Niederhoffer and Laurel Kenner talk more about taking risks, a foray into biotech stocks and indicators.