

>: Is Trading Rocket Science

Tuesday, June 26, 2007 / Wayne

NOTE: This article comes from another Tycoon Reader, Rocky Starr, who also happens to be a physicist -- great read!

Actually, trading is a lot more like astrophysics.

I'm not referring to the self-styled "Masters of the Universe" strutting about on Wall Street. No, the parallels run deeper than that.

Astrophysicists hunt for supernovae and other luminous objects, while traders prowl for equally hard to find objects like multi-bagger stocks. Both subjects are constantly in the news -- this morning "NASA announces discovery of giant Supernova" jostles for my attention with "Cahn not elected Motorola board."

We all desire to be rich, and we all look up at the night sky to wonder about our place in the universe.

Here I will refract basic Wall Street wisdom through the lens of my limited trading experience to illuminate some of these maxims and examine the (occasionally tenuous) connections between these disparate fields.

Let the Game Come to You

In astrophysics, this is known as knowing where to look, and waiting. If you're hunting for supernovae, for example, point your telescope at a relatively young galaxy with many massive stars. You're more likely to be rewarded with a satisfying flash of light.

Seemingly polar opposites as Jesse Livermore, the famous speculator of the 1920s, and Warren Buffett, the value investor par excellence, both claim to have made more money by waiting than by rushing into a trade. That alone makes it the single most important principle. Whenever I've identified a nascent trend, picked a dormant stock and then waited for the trend to unfold, it has been profitable.

About two years ago, the first rumblings of mergers began in the steel industry. At the same time, Brazil's economy was also starting to pick up. Based on these converging themes I picked a fundamentally strong Brazilian steel mining stock that had been trending sideways. That pick profited handsomely within a year when merger mania took off.

Expect the Unexpected

Enshrined in science as Gumperson's law: The probability of an outcome is inversely proportional to the square of its desirability.

The trading version is: The market exerts the most pain on the maximum number of participants.

it was under investigation by the SEC and there was significant short interest. This looked like a perfect candidate for a put option, so I bought deep in the money puts expiring six months later. This appeared to be a conservative play, but within a few days there was “out of nowhere” positive news on the company, causing a sharp rise in the stock price, aided no doubt by short covering.

By the time I closed out my put position, it had lost two thirds of its value. I could have avoided paying this tuition to the market by a longer stint of virtual trading before dipping my toes in risky waters.

Neither a Bull nor a Bear Be, But Be True to the Trend

Famed mathematician and investor Jim Simons of the Renaissance hedge fund employs an army of astrophysics PhDs.

Why?

According to the Financial Times, they use techniques honed in graduate school to correctly identify the long-term trend of stocks while ignoring the short term fluctuations. Astrophysicists use the same techniques to filter out the background and spurious noise when trying to identify distant objects.

Jason Jovine in a recent column showed how even a short term trader (“Mr. Walrus”) could profit enormously by a detailed knowledge of the trends of a few stocks.

Like most investors, I was only aware of the long side when I began stock investing. The tech bust of 2000 showed the dangers of ignoring cycles. Recently I’ve identified one emerging country bank stock that shows cyclical behavior within a calendar year. I’ve played it long, now I am short. I hope to find more such stocks.

It is a Fine Art to be a Contrarian

Thomas Gold was a Cornell astrophysicist who, along with Fred Hoyle, correctly identified pulsars as rotating neutron stars with strong magnetic fields. Later, he also proposed that life on earth originated with microbes living several kilometers under the Earth’s surface – a controversial theory that flouted conventional thought. He was no knee-jerk contrarian, just an independent thinker.

Successful contrarian investing is much more nuanced than just doing the opposite of the herd. If it were that simple, then buying when all analysts yell “Sell” or taking positions opposite to those of today’s famous hyper kinetic TV stock pundit would be profitable strategies. Usually they are not.

You’ve got to tweak it.

Last fall, with high oil prices and falling auto sales, the automotive service sector was in a funk. Heavy buying by an activist hedge fund left big tread marks to a stock in this sector. So far I’m quite pleased to have followed the smart money contrarians into this stock.

but it illustrates another important principle in trading:

Successful investors play the news by making insightful lateral moves while the majority is focused on the main event.

A famous example was the bond trader at Salomon Brothers who advised his clients to buy potatoes following the Chernobyl nuclear disaster. He correctly reasoned that nuclear fallout in Europe would contaminate food crops and therefore increase the demand on American potatoes.

That's the kind of insight I would like to develop.

Wayne