Taming the Lion

100 Secret Strategies for Investing

Richard Farleigh

The new star of Dragons' Den reveals his secrets for success

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Richard Farleigh

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For Camilla and the loves of our lives: “Toto”, “Baba” and “Loulou”.

With thanks to Janine Perrett, Peter Farleigh, Ross Thompson, Roy Travers, Robert Olson and of course, Marjorie Farleigh.

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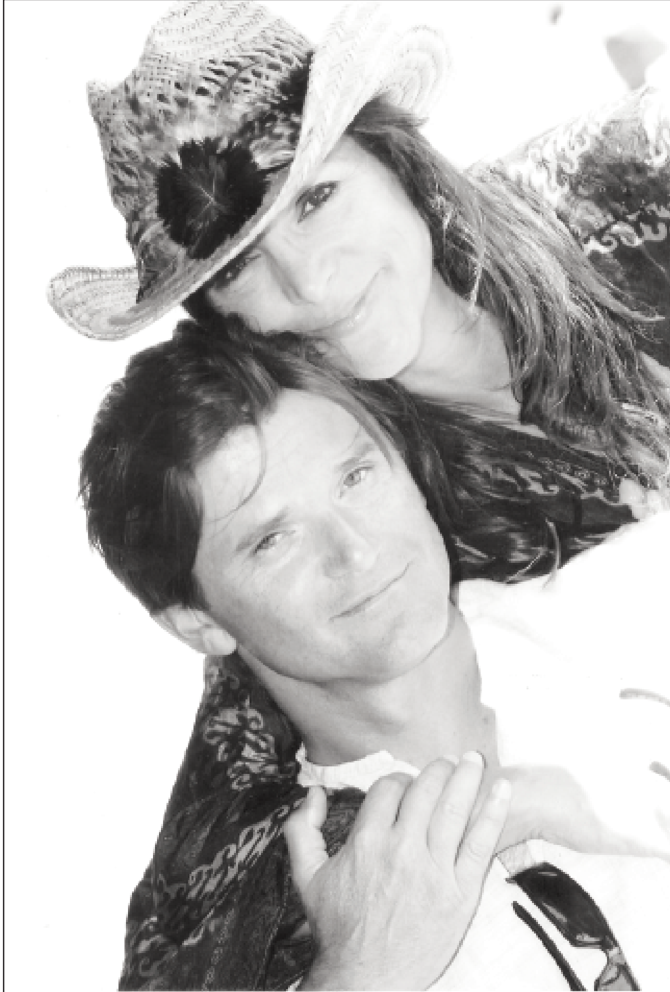


Richard and Camilla

Introduction

When I started my career in a Sydney investment bank in my early twenties, I did not believe that I could outperform the markets. As a former economist and a chess player, investment and trading just seemed to be a form of gambling. I had no idea how the markets could offer any opportunities.

Gradually, however, I came to believe that market prices are predictable, and within a few years I was running a trading desk dealing in hundreds of millions of dollars. Because I wanted a long and prosperous career, I developed a repeatable methodology which was based on observation and reasoning, not just on one-offs and luck.

I had many beliefs which went against conventional wisdom, some of which included:

- Markets tend to under-react, not overreact.
- Big, obvious ideas offer great opportunities.
- It is safe to invest with a consensus view.
- Contrarian trading is usually irrational.
- It is best to enter and exit the share market at the right times instead of always staying invested.
- Price trends are well known but under-utilised.
- Chartists are just astrologers.
- Investment and trading are increasingly similar.

Some things I simply tried to do better than other investors, these included being sure that I was chasing a genuine opportunity, managing my risks and coping with my losses.

I also developed some trading systems, which were still being used years after I left the bank.

As my trading results started to attract some attention, I was frequently asked to give presentations of my ideas to other professional traders. Question times often continued throughout dinner and in the bar. I learnt a lot from the feedback during these sessions. Like me, others were interested in an approach to investing which was based on first principles. I found that

anecdotes were the best way to make a point, and that by presenting the ideas as a list of strategies I could show clearly how the methodology works and provide a useful summary.

Years later, I am still using the same approach, and I have found that as well as the professionals, there are many amateurs who are keen to find out how markets work and how to improve their investment performance. These are the secrets that they want to discover.

Structure of the book

In this book I reveal those secrets and the thrills and pains I experienced in finding them. Many of these ideas and philosophies are now being adopted by successful hedge funds. They are presented as 100 different Strategies spread evenly over ten chapters.

Chapter 1 – Markets

My first trading experience resulted in a big loss. I was lucky! I quickly learnt how tough it can be. The most common mistake is to assume that investment success is easy. This is encouraged by so-called ‘expert’ views appearing in the media which imply that market prices are somehow flawed and that there are plenty of opportunities.

The irony is that in thinking it’s too easy, investors make it more difficult! It leads them away from the truth. The starting point must be that market prices are normally about right, and that any opportunities can only be found by identifying their cause and understanding how they work. We need to be careful – experts are vastly overrated. Most professionals in the markets are not actually outguessing the price, but are making money from clients, transactions and commissions.

The markets are increasingly challenging. Many opportunities that investors pursued years ago have simply disappeared. Speculation increasingly requires that the fundamentals are fully supportive. Even governments find it hard to push prices to the wrong levels.

Fortunately I have found one shortcut in the investment world which works very well: the approach in these Strategies can be used for many different

markets. I have used the same methods successfully over twenty years with currencies, bonds, property, stocks and private companies. It has enabled me to pursue investment opportunities wherever they may be found.

Chapter 2 – Comparative Advantages

An investor needs to spot genuine opportunities in order to make good consistent returns. A few market professionals can rely on the advantages of superior information, high quality analysis or client orders to help them predict future price moves, but for various reasons these advantages are dwindling, and anyway the ordinary investor needs something more accessible. Fortunately there are opportunities offered by market behaviour which are long lasting and can be spotted without enormous research or inside information:

- There remain patterns and anomalies in the markets.
- Markets are slow to react to big picture changes.
- Small companies offer more opportunities.
- Markets go further than generally expected.
- Markets move in underlying trends.
- A view on the fundamentals can be combined with price movements to manage trading positions.

When these are pursued with sensible risk management the results can be stunning.

Chapter 3 – Risk

Over a period of time, even the best investors will inevitably suffer losses. Unfortunately even good ideas can lose money just as bad ideas can sometimes make money. There is inevitably a high degree of chance or luck involved. The most important thing is to manage the risks and to ‘stay in the game’. Investors need to think about how far a price can move in the wrong direction. They also need to diversify, be able to cut losing positions and withstand the stress involved.

Chapter 4 – Patterns and Anomalies

I have spent my professional life looking for patterns and anomalies. There are many in the markets which are useful to understand. Shares, bonds, currencies and property all offer unique challenges and opportunities.

A good idea can often point to more than one type of investment. One example is that a strong economy is bullish for both stocks and property, but property may be the easier play because it has smoother cycles.

Another pattern in the markets is that crisis situations almost always provide opportunities to those investors who can remain calm and who have kept some powder dry.

Chapter 5 – Big Ideas

Big ideas can make big money. There is a host of examples: the big falls in inflation, technological innovation, emerging economies and China's appetite for raw materials are just a few. The big ideas cause big but slow changes in many markets. Seldom are these expected by economists and analysts who often struggle to see the wood for the trees.

Investors should look for these big ideas and ignore anything which is too obscure. With those small things it is normally too difficult to out-analyse the analysts.

For investors in mainstream markets, the big idea they are pursuing is often the state of the economy. It's too hard, for example, to make money on the broad stock market when the economy is going into a recession, so at that time bonds are a better bet. A useful way for those investors to keep an eye on the economy is by a simple checklist of the positives and negatives.

Chapter 6 – Small Companies

I am convinced that small companies offer more opportunities than larger companies. There is a greater chance that they are mis-priced in the market because there is a big variation in their quality, they are often involved with new products and they are not as widely followed by analysts and investors.

For a small company, the competence of the management is the most important feature. Other things investors need to look at are, of course, the company's products and markets and its ability to handle growth.

Chapter 7 – Price Behaviour

Time and time again I have watched market prices go a long way and surprise just about everybody involved. In recent years, there have been moves, like the rise and fall in the NASDAQ, the rise in the oil price, the rise in house prices and the weakness of the US dollar. These market moves are opportunities, because in each case the market takes its time to react to big ideas and big changes. All the way along, people are sceptical and they don't expect the price move to continue, so investors need to expect the unexpected. They shouldn't cut winning positions too early, and they should accept that the old price levels are history.

Chapter 8 – The Understanding and Use of Trends in Prices

I am able to show that trends have operated across nearly all markets for a long, long time. These price trends are a gift! A market that has moved higher is more likely to continue moving higher than to suddenly reverse. The equivalent applies for a falling market. Although trends are well known in the markets, their implications are ignored (even denied!) by mainstream thinking. For example, despite the common belief, markets tend to under-react, not overreact. Trends can be used to make money; for years I have experienced a lot of success using simple systems which use nothing but trends, and trends can help decide the best way to time investments.

There are solid reasons why trends exist and will persist in the future. Market information spreads gradually, and the reaction is delayed by inertia and scepticism. Rising prices can actually lead to more, rather than less, buying in the market. Economic cycles also help prices move in trends.

Chapter 9 – Market Timing

Even the best investment ideas can come unstuck due to bad decisions on when to buy and sell. The best technique for entering the market is to wait for a price trend to verify a bullish or bearish view. So it is not a good idea – unless there is market panic – to buy into falling markets. Being a contrarian means fighting against trends and not acknowledging that markets can go further than expected. It may work occasionally, but it is against the odds. Similarly, add to winning trades, not losing trades, and

don't be scared if you are investing alongside the consensus view. For a price to go a long way it will require consensus agreement at some point.

The decision to exit should only be made when the reasons for the investment are no longer sound, or when the price trend has reversed. Sticking with winning trades for as long as possible is the only way to make big wins.

Chapter 10 – Avoiding Temptation

I believe that really good investors can avoid temptation. They have the discipline to know when there are no genuine opportunities and not to take excessive risks. In these situations, it may be useful to keep an eye on a variety of markets and to see if any price trends develop. These may signal when something is happening which is worth investigating.

Be careful in these quiet times, because even simple wealth preservation is not straight forward due to taxes and inflation. Sophisticated retail products may appear good on the surface but require close scrutiny. With a passive portfolio, management and brokerage fees should be kept to a minimum.

A brief biography

By Janine Perrett

I first met Richard in 2000 through mutual friends. He had just helped turn a rundown Georgian mansion in London into a successful private members' club, and he was being lauded in the business pages for his support of emerging technology companies.

He was, in short, an ideal candidate for a story on my Business Sunday programme on the national Nine Network in Australia, particularly as, despite his success, he was not widely known in his homeland.

After the programme aired in May 2001, we were inundated with hundreds of letters and emails, many hailing his success, many more emotionally moved and inspired by his personal triumph over the odds.

Here is his story.

The country town of Kyabram lies 200 kilometres north-west of Melbourne in the southern Australian state of Victoria. In 1960 it had fewer than 5,000 residents but it boasted the newly opened Kyabram District Memorial Community Hospital, and it was here, on November 9th that Richard Buckland Smith was born.

His middle name was a nod to his ancestors who can trace their roots back five generations to the infamous Rum Corps rebellion. Such long links are important in such a young country where being a sixth generation Australian is something to be proud of. In fact the name was probably the only thing the troubled family had to be proud of at that moment in their history.

His father, Richard Geddes Smith, was probably just passing through Kyabram at the time of the birth, as his occupation is variously described as shearer, opal miner and seasonal labourer. His mother, the former Millicent Duggan, had already borne much, including seven other children; Richard was only the second boy. Before he was born, a baby sister had died after drinking bad water from a river close to where the family had camped.

In his brief time with his natural family Richard never knew what it was like to have a proper home, or even live in a normal house. They travelled the countryside in an old truck with all the children in the back, open to the elements. Rodney Smith, who was eight when his brother Richard was born, recalls when the weather was bad they would all sing "rain rain go away, let us live in a house one day". A tent was carried in the truck to shelter them all when they next made camp.

Rodney does not dwell on the unpleasant aspects of their childhood except to concede he suffered a fractured skull once courtesy of his alcoholic father. There's no doubt it was a violent childhood as Richard reluctantly recalls his very first memory was one of "fear".

When Richard was barely two years old, all the children were taken into care by the State. The fact that so many children were taken from their parents indicates how appalling, even then, the authorities regarded their situation. Being the 1960s, the unenlightened Australian social welfare system made no attempt to keep the children together. They were all split up, never to be reunited as a family.

Probably because he was still only a baby, Richard did not have to spend too long in the home as he was soon taken into foster care by Marjorie and Keith Farleigh from Peakhurst in Sydney's south-western suburbs.

Marjorie's first impression of her new son was that "he was a lovely little boy", but even though she thought he looked healthy, he soon came down with a terrible bout of measles. During the illness one of his eyes 'turned' and he was forced to wear a patch. Richard was confined to a darkened room with daily visits from the doctor. It would take two operations to correct the problem and by then he was five and already at school.

The Farleighs were under the impression they were only minding Richard for a few months until his parents wanted him returned. In fact Marjorie kept his bag and all his clothes packed and ready for when they sent him back. However she decided this delicate little boy needed her, so the next time the welfare officer visited, she informed him "Richard will be staying".

Apart from one strained reunion when he was four, Richard had no contact with his natural family while growing up. While the Smiths had three other children, some of whom they simply gave away, as well as the seven who

were fostered out at the same time as Richard, it was not until he was an adult that he made contact with his other siblings.

His mother died in the 1990s and he lost track of his father – in fact the last time he recalls seeing him was a chance meeting at a Sydney railway station where his itinerant father was sitting on a bench with his harmonica and swag.

While it's clear Richard was lucky in finding a stable home with a loving foster mother and two caring foster brothers, Peter and Ian, his relationship with his foster father was never close.

Richard's first kindergarten teachers placed him in the lowest class as they misinterpreted his chronic shyness and reluctance to speak as a sign of being backward. A turning point came in Year 5 at Peakhurst Primary school when he was about eight years old and was lucky enough to get into the class of a teacher called Jan Walker. She is still at Peakhurst, a principal these days, and recalls her first impressions of Richard as being small for his age and very shy, but even then she recognised his aptitude.

She remembers:

"He was a ghost in class and his self-esteem was not great. He was not doing well in English, but he was far ahead in mathematics and I told him – 'you have a lot of potential. You haven't reached it yet and you won't do it for a long time, but you're going to do well'."

It was after he entered Narwee Boys High that another important turning point came for the introverted youngster. At the age of 12 his brother Peter taught him to play chess. It was to change his life.

"I was pretty unhappy the whole time I was at high school, but chess made me feel a bit better." Richard says, "Suddenly I really started not to believe the negative things I felt about myself".

For Richard, the game that started out as hobby soon became a passion and he quickly rose to the rank of Junior State Champion. A whole new life opened up as he travelled the country attending chess tournaments, making new friends and finding a previously unknown confidence in his ability. Years later he would represent Bermuda and Monaco in the Chess Olympics.

After high school Richard decided to study economics at the University of New South Wales, and by topping an exam he won a generous scholarship from the Australian central bank. He graduated with first class honours in economics and econometrics but decided against doing a PhD, and chose instead to accept a job offer from the leading Australian investment bank of the time, Bankers Trust Australia.

Still shy and lacking confidence, the 23 year old began working in the derivatives business for the then CEO who reportedly told colleagues he doubted the youngster would ever succeed and that “if he makes a buck for the bank, I’ll walk backwards to Bourke”. That’s nearly 800 kilometres from Sydney.

Richard ended up becoming the bank’s biggest single money earner.

In his 1999 book, *One of a Kind: The Story of Bankers Trust Australia 1969-1999*, writer Gideon Haigh described Richard as “one of the most fascinating characters” to pass through the investment bank:

“As he began taking more views and more risks, Farleigh’s earnings and reputation grew. He evolved some first principles of trading. Markets tended to overreact in the short term and under-react in the long term. Investors tended to work off price rather than fundamentals.

He was militantly against chance. He was also out of sympathy with other trading schools reliant on data mining and regression analysis. His modus operandi was forward-looking - if a, then b, suggesting c - and his mentality that of a purist:

‘I hated it if you put a position on and it just happened to work, because I felt that left you with nothing for next time. I didn’t like charts, either. That was hocus-pocus. I was a fundamental trader. That’s much harder than being a technical trader.’ ”

In the book, Richard’s former boss, Bruce Hogan, recalls:

“Richard always had a very clear view of how the market would unfold. And, when it didn’t go according to expectations, his disciplines getting out were intense. Even when Richard made losses, I was always impressed with the rigour of his post-mortems. Was it a bad decision? Or was it actually still a good risk-return decision where something of a lower probability happened?”

By 1993 Richard was in his early 30s and earning a seven figure sum as the star trader, when he was headhunted for a powerful and secretive international hedge fund based in Bermuda. On this idyllic island tax haven he was able to refine the crucial trading style which he had been developing at Bankers. He described his three years here as “trader’s heaven”.

He did well enough to retire to Monaco at only 34 with his then wife Sharon and baby son Thomas. From this tiny tax haven filled with wealthy individuals from around the globe, he began to look for other opportunities to make money outside the strict constraints of the trading floor. So he turned his hand from currencies and interest rates to UK tech stocks and in the following years he backed over 50 early stage companies.

By the time the ‘tech wreck’ began in 2000, Farleigh had been investing in technology for five years. While he was hit by inevitable and difficult losses, his earlier profits provided him with a crucial buffer, and with the recovery of the market, some of his companies now read like a who’s who of new market listings in UK technology.

While he was pursuing this investment activity, another, totally different opportunity presented itself in the form of Home House. This architectural masterpiece, which had once housed the French Embassy during the Revolution, was on a list of the world’s 100 endangered buildings. The idea was to restore the building and to make a fantastic private members’ club.

“It would be nice to be an Australian saving one of the Pommys’ endangered buildings”, he said with a touch of the larrikin.

And it worked. The club soon became the most sought after venue in London, with a celebrity-filled membership list including Madonna and a host of numerous high profile functions including a big ‘Brit Awards’ after-party. Even though Richard and his partners sold out of the club in 2004 he still maintains strong ties and visits frequently.

He continues as an active investor in early stage technology companies.

Richard now has another two children, Jasmine and Lucas, with his partner Camilla, and they divide their time between Monaco and London.

Janine Perrett

Sydney, May 2005

On father's shoulders - before the children were taken into care by the authorities

A day in the life

In the first Gulf War, US forces overwhelmingly attacked Iraqi forces in Kuwait. It was an awesome display of military power, and almost the whole world was surprised and amazed at how powerful the US military had become. They had moved to a new level: missiles with cameras attached that could be steered through the front doors of buildings, and strange looking black planes called 'stealth bombers' that were invisible to radar. Iraq's feeble response looked hollow following Saddam Hussein's earlier "mother of all battles" threats, but if he could have mustered enough anti-American sentiment in other Arab nations, he may have pulled an armed rabbit out of the hat.

Financial markets around the globe were preoccupied with the battle. The oil market was naturally the most affected; the spot price per barrel was driven from the high teens to over 40 dollars, as traders contemplated a huge disruption in supply. The stock market worried about the recession that would result if the oil price stayed so high for too long. Interest rates were pushed sharply higher by the potential inflationary effect of the rising oil price.

Traders in the markets all scrambled to learn as much as they could about oil and the Middle East as quickly as possible. It was a change from the boring old employment numbers and inflation figures which everyone normally had to scrutinise. If Saddam set alight oil wells, as he threatened, would they really burn for a hundred years, or could they be extinguished by having big domes put over the top? And what would happen if he spilled a massive load of oil into the sea and set it on fire? Anyone who might know the answers suddenly got their fifteen minutes of fame. Oil experts were brought into the trading rooms and treated like celebrities as their information was needed to make a rational view of any of the markets.

From a trading room in Sydney, my perspective was just as confused as anyone else's. Even though my job was to take risks with money, there was no way I had any competitive edge to allow me to think the markets had got something wrong. For the previous year or so I had been betting strongly on falls in interest rates. I believed that the economy would be weaker than generally expected and that inflation would be driven lower. For me this war

was an interruption to a slow economic trend. War was too risky for a bet and I had cashed in my chips – I was out of the market.

Although I didn't want to bet, I could still watch. Investors were looking for safe places to put their money: the gold price and the American dollar had risen. For gold a rally was normal — during a world crisis gold is the hero. It's all about probabilities. Even if the world's not about to end, there is a slightly greater chance of chaos. Paper money relies on people's confidence in a government, whereas gold has intrinsic value. In post-war Germany, people needed a sack full of money to buy bread. If they had bought gold earlier they could have maintained their wealth. So the market's extremely sensitive barometer to chaos was rocked by the Gulf War, and the gold price had been pushed significantly higher. Another reason gold rallied was the inflationary threat of the higher oil price, because inflation is bad for paper money but good for commodities.

The rally in the dollar also made sense. During a crisis it makes sense to have your money in the hands of a superpower, especially when you've seen the effectiveness of their military on CNN.

When Iraq started lobbing missiles into Israel, the war reached a critical stage. Saddam's thinking was simple: if Israel could be provoked into retaliating, other Arab nations would see a broadening of the issues and perhaps come to Iraq's defence.

Time passed. The dollar climbed even higher. I think gold was actually starting to struggle to hold its gains, and I remember thinking: "If gold can't go higher on this news, when on earth will it? Maybe it's time for investors to sell?" However the only bet I took was against the dollar. I reasoned that Israel would listen to the US, who would instruct them not to retaliate under any circumstances. Given that the allied forces were clearly superior, if there was no broadening of the conflict, the markets would soon calm down. So I sold dollars for marks and waited.

Fortunately for the world (and for me), Israel stayed passive and I was then able to close my position for a profit as the dollar later declined.

It can be profitable and exhilarating — but let's start at the beginning

With the story above I have tried to reveal some of the thoughts that ran through my mind while I was trading. Investment can be nerve-racking and exciting. Even when there is confusion everywhere, it is possible to find ways to succeed by using logic and by understanding how markets work.

These are the things I love to discuss and analyse. However, in this book I need to start at the beginning. The first two or three chapters are essentially warnings and background ideas. Please be patient. Only after covering that material can we get into the fun part of how I believe you can make money from trading and investment.

With Peter and Marjorie Farleigh

1 Markets

1.0 The different markets have many useful similarities

As a youngster my first ambition was to be a bushranger just like Ned Kelly. This nineteenth century outlaw was Australia's own Robin Hood, except that he fought against police injustice wearing his bullet-proof helmet and vest made from steel. Eventually caught and sentenced to hang, his last words were "such is life".

My ambitions improved slightly as I grew older, and in my teens I thought of being a religious minister, or of trying my luck as a professional chess player. These things faded, however, and as I finished high school in Sydney in the late 1970s, my plan was to be an economist. The little bit of economics that I had learnt had whetted my appetite. Economics is often criticised as the 'dismal science', and there is a joke at its expense which states that you could line up all the economists in the world and still not reach a conclusion. But I had good teachers, and one of them in particular, Peter Rolfe, showed me that economics achieved a hell of a lot by starting with some quite acceptable assumptions about human behaviour. From there, it is able to do a reasonable job with the daunting task of predicting the actions of millions of people when wages, prices, interest rates, taxes and other financial factors change. Peter is a fun and sporty person, so he was quite an evangelist for the subject.

A few years later, I had finished my degree and found myself working in the Research Department of the Reserve Bank of Australia, which is Australia's central bank. From there, however, I made a quick career change and entered the hyper-competitive world of investment banking. I had been told that the money was good, but that you had to be able to handle the stress. I remember thinking "hmm, I'll try to make some money, and I'll worry about the stress later".

My career since then has been unusual because, as a trader and investor, I have been involved with many different types of markets. Since the early 1980s I have been a derivatives trader, a bond trader, a currency trader, a business angel and a stock investor. I have worked for an investment bank,

a private hedge fund and for myself, managing my own funds. I have been very lucky because I have enjoyed all of it immensely, and I have produced good returns for others and myself along the way.

The most striking and satisfying thing that I have learnt from this experience is that the different markets have many similarities. This is contrary to what many people expect. I believe that in all markets:

- Any genuine opportunity needs to be based on a sound observation.
- Big ideas offer big opportunities.
- Prices take time to absorb information.
- Prices go further than generally expected.
- Prices move in trends.
- Crisis situations and panic buying or selling occur from time to time.
- Investing requires a sensible approach to risk management.
- Analysis requires recognition of both the bullish and the bearish arguments. A checklist is very useful.
- 'Experts' are often wrong, and the media oversell how easy it is to make money.

Because of these similarities, the various investing and trading opportunities offer the same types of challenges and opportunities, and they can be approached in much the same manner. I have even found that, for example, investing in an unlisted biotech company involves some similar skills to trading euros versus the dollar.

The ability for an investor to change focus can be very useful as investment opportunities shift from one market to another. In the late 80s and early 90s there were fantastic investments offered by the big falls in interest rates in the western economies. For nearly a decade after that opportunity waned, it was the stock market which had a brilliant run. More recently, commodities have been surging.

Investors and traders who only look at one type of market can be trapped without these big opportunities. They are trying to grow flowers in the desert. Sometimes, it can be useful to move elsewhere.

Consequently the 100 Strategies are applicable to a very broad range of investments. The idea is to find the right ideas and not waste time and money trying to eke out a return from barren areas.

Trading and investment are increasingly similar

It is probably best to clarify at this early stage that I believe trading and investment are increasingly similar. Traditionally, there is a distinct difference between the two. Investment is putting wealth into different markets with a long term view. Adjustments to the portfolio are made infrequently and at a slow pace. Trading, on the other hand, is holding positions for shorter periods of time, looking to make a faster profit, and then exiting. Investment tends to be buy and hold, whereas trading tends to be based on temporary reasons with an exit when those temporary reasons have dissipated.

However, successful investment increasingly recognises that the buy and hold strategy may not work. It may require a more timely response to what's happening in the markets, since they can move a long way in a fairly short period of time.

Equally, as we will see, many short term trading opportunities in the markets no longer exist, and now the best opportunities may have a time horizon that extends into months and even years.

So, in these Strategies, I will not try to distinguish between trading and investing, and I will use the terms interchangeably.

Fundamentals

I will also use the term market 'fundamentals'. These are all the factors affecting a market. Anything that influences, or potentially influences, demand and supply is a fundamental, whether it's social, economic, political or the natural environment.

1.1 Fear the market

My first ever trading experience was a disaster. In 1984, fresh out of university, I started trading futures in my spare time. Futures can be very risky because of the leverage – whereby a small deposit can give you a large exposure to price moves.

I can't remember why I was ever tempted into trading, but I do remember the result: over a few months I lost four thousand dollars. It was a lot of money to me, which I couldn't really afford since, as a trainee, I was earning less than twenty thousand a year.

My mistakes

I had no experience and I did all the wrong things:

- I started with positions which were way too big.
- I stopped and started a new strategy every few days.
- I had no long term view.
- I didn't really understand what was driving the market.
- I grabbed profits as soon as I could and stayed with losing positions.
- I listened to the views of other people who probably had no idea either, including brokers and people with fancy charts.

The result was to scare the life out of me. I had thought you could make money by trading, but I became convinced that it was impossible. I squared all of my positions and decided never to trade again.

Although it did not take long for me to break that vow, I have never forgotten that first unpleasant experience. Even now, when I make investments, I have a fear of the markets, and perhaps an underlying scepticism of my ability to outwit them. However, I am convinced that over the years, the fear I first experienced at that time has saved me a lot of money, and allowed me to stay in the business of trading.

I want you to have that same level of respect. I want to convince you that the market can be a horrible place where your money can just disappear very quickly. You're throwing dice, tossing coins, whatever. There are no certainties and you don't know what you're up against.

"A hard way to make an easy living"

Cleanse yourself of any idea that it's easy. You're in for a difficult time. Like me, most traders and investors have had to learn this the hard way, at one time or another, by losing money and agonising over bad positions. By giving you this warning I'm trying to save you from that nightmare.

The market is much more difficult than you think. It acts like a huge super-computer as it effectively absorbs an unbelievable amount of information – more than any human being could fathom.

When you buy or sell in the market you are hoping that the current market price is wrong, that the super-computer is wrong. Now stop for a moment and think how incredible that would be. If you believe that the dollar will fall, what you actually believe is that the current price is flawed, even though it is the result of a huge amount of people dealing in a huge amount of money.

For that reason, when I am asked for my view on a currency or another market, I'm very reluctant to disagree with the price as it stands. I personally give the markets that level of respect – and I've been battling them with some success for a long time. Yet many people who lack any experience will happily put forward their view with an astonishing degree of unfounded confidence.

Don't forget that these days there is intense analysis by funds and banks and that they still regularly get it wrong – often spectacularly wrong. So start with a degree of caution. Be like a lion tamer. The lion can be tamed, but only by maintaining a healthy fear of the lion.

1.2 Markets are more efficient than generally acknowledged

I often think of the market as an opponent, a living being to outwit and defeat. To 'beat the market' we need to look for weaknesses in our opponent's armoury. The problem is that our opponent is nearly perfect. It is very 'efficient' at setting prices that offer no opportunities. If we buy and sell on just whims, or on unfounded ideas, we cannot win the battle.

I often think of the market as an opponent, a living being to outwit and defeat.

Efficiency in markets is a concept stemming from economics. Quite simply, an efficient market is unbeatable. It sets a price whereby you may as well toss a coin to decide whether to buy or sell. At any time, the price completely reflects all relevant information. There is no point taking the view that because of factor X, a market is undervalued; factor X is already known and factored into the current price.

No opportunities in an efficient market

One consequence of an efficient market is that prices move in a random manner. All current information is already reflected in the current price, which means that the price can only move in response to new (and thereby, as yet, unknowable) news. Therefore there is no trend, and no one can predict what the price is going to do next.

Microsoft shares could be a good example of market efficiency. As I write, their price in New York is $24.91. This is the price that reflects all the known information about Microsoft. As ongoing information emerges about the company, it is disseminated quickly, traders buy and sell on the basis of that information, and the price moves accordingly. Your guess is as good as anyone's about where the price will go from here.

An efficient market offers us no opportunities. It is an opponent without weaknesses.

Fortunately, markets are not always efficient

Luckily for us, however, the markets are not always efficient. The most likely reasons that a market fails to operate efficiently are that:

- All the relevant information is not equally available to all buyers and sellers. An example would be a bargain in the property market which exists because too few buyers are aware of the opportunity.
- The buyers and sellers all have the relevant information but do not sufficiently understand the implications of that information. Here an example would be when people continue to pay high prices for property even when they know that the economy is going into recession.

Occasionally, it is suggested that some illiquid markets – where there are not many buyers and sellers – are inefficient because they can be unfairly dominated by a few players. However I will argue later that those players usually lose out.

It is possible that markets are inefficient when they are deliberately fed misleading information, as happened with Enron and Worldcom, but hopefully that type of malpractice is on the decline.

With these Strategies, I will try to identify, in a very structured and disciplined manner, where it is that I believe the market does not operate efficiently. This is where we will find opportunities to beat the market.

Unfortunately, most people do not approach trading and investing in that way. Rather, they start with an assumption that the markets are inefficient and that there are obvious buy or sell opportunities. They have vague, untested beliefs, and make comments like 'the consensus is always wrong', or 'the market always overshoots'. Both of which we will see are completely untrue.

1.3 Market opportunities are disappearing

When I entered the world of finance in the mid 1980s I was fortunate enough to join the right investment bank: Bankers Trust Australia. With a reputation as the highest paying employer in Australia, it was *the* place to work. The people were very creative and motivated, and it operated as a genuine meritocracy with little bureaucracy or politics. At one stage, in terms of percentage return on capital, it was rated as one of the most profitable banks in the world.

I was put to work in the trading room, which I found amazing. I was a bee in a beehive – all around me there was activity. There were about a hundred of us in the room, with lots of screens and telephones and paper everywhere. There were all types of people, and most of them were very engaging and friendly. Everywhere, the mood was generally upbeat and there was a lot of joking around.

The room was divided into a number of different departments: foreign exchange, bonds, money market, options, and the area I joined, cross-markets. With a mix of clever people and abundant market opportunities, all of the departments were humming along making money.

It was a time when the winds of change were howling through the markets. By aiding their design, personal computers were allowing financial products to become far more sophisticated – the abacus and slide rule could be thrown in the bin! Improved communications such as mobile phones were making it easier to keep track of what was going on around the world.

On top of this, governments were encouraging greater competition in the financial sector. The lazy old-fashioned banker, who enjoyed boozy lunches and golf days, no longer found life so easy. Suddenly there was pressure to offer competitive prices and to be more innovative.

The search for market inconsistencies

In cross-markets, one of our roles was to look for market inconsistencies, and to take advantage of them using the bank's own funds. We were also responsible for the pricing of swaps, (sophisticated products that can protect businesses from volatility in currencies, interest rates and other markets).

Both of these activities were slightly complicated, but they were relatively low risk because we would simultaneously buy in one type of market and sell in another, leaving us with only a small exposure to market moves. After getting a grip on the mathematics involved, we usually had some time to plan our strategies, and to allow our positions to bear fruit. This type of thing suited me. I would never have made the grade if my job was to juggle phones like the book makers, or shout at the top of my voice like the floor traders. I liked having the chance to think, and to be able to watch things unfold over time.

Due to the relatively low risk, we were able to really go for it – our trades involved very large sums of money. So, here I was in my early twenties, with a few grand in the bank, a cheap suit and no real experience, and I was on the phone doing deals worth tens and hundreds of millions. I was so happy to feel that important. I knew I'd been given a big chance, and I didn't want to mess it up. I had to be careful and check the calculations carefully before I did anything. Even a slip of the tongue could be dangerous, because saying 'buy' instead of 'sell' could obviously cost a lot of money. Once I fretted for an entire weekend thinking I had made just that mistake. On the Monday, I found that I hadn't. The relief was like waking from a bad dream.

I stayed in this role for three or four years, and during that time we enjoyed a lot of success despite the low risks. It was great, there were no major problems and I became accustomed to dealing in large amounts of other people's money. It was lucrative too. I had nervously taken a pay cut when I joined Bankers Trust, but my salary took off like a rocket and continued to

rise while I was at the Bank. Starting at twenty thousand dollars at the age of twenty four, it more or less doubled every year: to fifty, one hundred, two hundred and fifty, five hundred, and then to one million and beyond by the age of thirty. That was big money, especially fifteen years ago. My friends couldn't believe it, and I couldn't believe it would go on. So, like a squirrel, I saved just about all of it.

Not so easy now

As I look back on that era, it's clear that a lot of the ways that our trading room made money have simply disappeared. The markets have become relentlessly more sophisticated as the changes that started in the early 80s have continued. Nowadays, everyone is extremely well qualified, there are computer programs everywhere and there are instant communications. The market has evolved, like bacteria against antibiotics, to beat out opportunities. This has happened as people have spotted opportunities and exploited them till they no longer exist.

So over the years, as my career progressed, I have looked for high quality opportunities which are somehow resilient. I will present these in later chapters and explain why I believe they have persisted while others have been eliminated.

1.4 The markets can overwhelm government intervention

In September 1985 the world's biggest governments met at the Plaza Hotel in New York and reached an agreement: the US dollar was over-valued and needed to fall.

The effect was stunning. With the market aware of the new "official" preference for a weaker dollar, and some ten billion worth of dollars sold into the market by the governments as a show of force, the dollar dropped dramatically. In the following two years or so, it halved in value versus the other major currencies. An astonishing success for government policy.

However, this success was more of an exception than a rule. In fact, markets are normally too big to be bullied.

Countries of all sizes have often been tempted to try to dictate the value of their currency by intervening in the markets. Sometimes they want to lower

a strong currency, but more often they want to prop up a weak currency. In some cases a falling exchange rate can be seen as an embarrassing assessment of political integrity and economic performance.

So governments enter the market with one thing in mind: to move the price. They buy or sell aggressively, and may add to the drama with a big announcement about government policy and commitment. The effect is immediate. Like a shark at a beach they cause widespread panic. Speculators and dealing rooms all over the world scramble to adjust their positions, and the media give the news top priority.

It was in the middle of one such episode a few years ago, when I had the idea to investigate the longer term effect of government intervention. The government was intervening aggressively in the Australian dollar market and there was a flurry of activity around me in the dealing room. Looking at the prices flashing on the screen, I wondered if the market reaction was very long lasting. Sure enough, my subsequent research showed that while falling currencies typically bounce after government action, in less than a month or so, they resume on their downward path and continue to weaken towards fresh lows.

So by spotting this pattern I had found a new, profitable strategy. Whenever the market had this kind of knee-jerk reaction to government intervention, I would bet against it, on the assumption that the bounce was only temporary. I was effectively backing market fundamentals versus the government.

The fact that even governments, with all their muscle, cannot reverse the market has always impressed me. It shows the depth and efficiency of the financial markets.

Keep that in mind when you think that the market price is wrong.

1.5 The market is strengthened by speculation

Over the years I have heard a great deal of criticism about speculators. It often pops up when markets or currencies are having a dramatic fall. Funny, speculation doesn't seem to bother so many people when it's pushing prices higher. Should speculators be ashamed? No, the fact is that the market needs them.

Speculators add important liquidity. I often invest in small stocks, which would not have much daily turnover if it were not for speculators. The longer term holders of these stocks do not buy or sell very often, so when I need to find a buyer or a seller, it is a great benefit to have speculators as they are much more active.

Speculators also play an important role in absorbing risk that others don't want. Wheat farmers, for example, may sell their crop well before harvest at a fixed price for a future delivery date. That way, they can remove the risk that there is a bumper season and an oversupply that forces prices lower. The buyers may be speculators who are happy to take on that risk – without the speculators, the farmers may have no one to sell to.

You often hear criticism of speculation based on the flawed argument that it pushes prices to unrealistic levels. The thing is though, speculators are usually punished when they do this, because if they are wrong about real values, they are usually the big losers. The tech boom and bust, where perhaps it was speculators who drove prices to very high levels, is a great example. Most of them paid very heavily when market prices crashed to a fraction of the higher levels. Though what a great opportunity it was for the more savvy investors to sell near the highs.

So, speculation is usually only successful when it is in line with the fundamentals, and when it is pushing prices to a level that more closely reflects fair value.

George Soros and Black Wednesday

A great example of this is George Soros. He has been criticised because his massive selling probably caused the devaluation of the British Pound in 1992. In fact the resulting weaker currency and lower interest rates saved the UK economy, because they were more appropriate for the conditions at the time. The date (16th September 1992) is known as 'Black Wednesday' because the currency was pushed out of the European Exchange Rate Mechanism (ERM), but in my view it should be renamed 'White Wednesday'. That day is one reason that the UK has only five per cent unemployment, while Europe, which stuck with cripplingly high interest rates for way too long, has about ten per cent. The feeling was that Soros was a greedy speculator who made a billion pounds in profit, but in fact it has proved to be a very cheap price for the British, because the lower pound – and the resulting lower interest

rates – allowed for a big improvement in the economy. If the man in the street knew how things worked, Soros would be seen as a hero, not a villain!

For this reason, many commentators are naïve when they criticise these price shocks and the speculators involved. It can be better to have wild swings in currencies and other prices than lots of people losing their livelihoods.

It was a similar case in the late 1990s, when Malaysian Prime Minister Mahathir attacked currency speculators because they were pushing down the value of his currency. Again, speculation wouldn't have worked unless there was a solid reason behind it. A few years later, the consensus is that the currency was too high for the economic conditions at the time.

The speculator is often just the messenger.

1.6 Respect the market not the experts

The power of the financial markets should be daunting, but many people are not deterred.

I have friends in Monaco who are amateur currency traders. They don't have the same experience, resources, or the skill, of a George Soros. Nor do they follow the disciplined approach to trading that is recommended in this book. It's completely crazy that they think they can win. Why do people underestimate the difficulty of making money in the financial markets? I believe there are two main reasons.

The first, which I will discuss here, is the experts in the media. The second is the widely held belief that many professionals are regularly able to beat the market. This I will discuss in the following Strategy. I won't dwell on a possible third reason, which is that some people like to trade the market because they are gamblers. That usually ends with disastrous results.

'Experts'?

The experts in the media promote the idea that markets are easier than they really are. A guy on TV or in the newspaper says that the price is going to do this and do that, and it sounds easy. The market can be beaten.

If the media put out a continual broadcast that the market has processed all the information and that the price is right, people would get the message. But they rarely say that. The message is that the behaviour of the market can be

forecasted. It's a persistent and seductive message, and people think 'ah, I can have a go at that, I can make money out of that'. You can't blame the average person for following what they read in the newspaper and what they're being told on TV. However, many so-called experts are just commentators or analysts who often don't have any track record and who often, to my ear, don't even make much sense. Follow my advice below and listen critically, rather than just accept what you're hearing or reading. You may be surprised to find that they're not really experts.

Not that I blame the media for their financial guesswork. It can be very entertaining. But like a lot of gossip, the fact that it's entertaining and interesting doesn't necessarily mean that it's the truth.

1.7 Most professionals are not outguessing the market

You may heed my early warnings that the markets are difficult and that the media underplays the difficulties, but you may also wonder about all the money made by the people working on Wall Street or in the City of London. Surely they know something about markets?

Let me put you straight on this. The truth is that very few are successfully backing their views on markets. Most of them wouldn't have a clue what the market was going to do. They make money in other ways, such as commission and management fees.

It's not that people working in finance don't know anything – they are usually very good, very smart people. I respect a lot of them and many are my friends – but the fact is they're making money out of sales, client relationships and by doing transactions, i.e. facilitating the whole process. They're not actually making money out of successfully predicting what's going to go up and down. They are, therefore, not a reason for you to take up punting cotton futures in your spare time.

Equally, don't be too impressed with your stockbroker just because they sound confident and know a lot of stories and figures. More information does not necessarily make the market more predictable. The extra information is probably useless as the price has already adjusted for it - it has been 'priced in'. It's about as useful as playing roulette and knowing whether the roulette wheel was made in Taiwan or Korea. The critical test is: does the broker make a living out of picking stocks? Probably not. He or she is sitting

in their seat because they're getting the fees you pay them to buy and sell on your behalf. It's very easy for someone to have a view when it's with someone else's money.

1.8 Listen and read very critically

If you are trading or investing, the media probably plays a large role in forming your views, but it always surprises me how often they present faulty logic. So it is vital to learn to be critical of what you read and hear.

Try to spot mistakes such as those in the following real examples.

"Experts say the market is overvalued."

This is a subject I have already touched on. 'Experts' is the most overused word in finance. I see it all the time and wonder who these experts are! The only expert who interests me is someone with a proven track record of predicting the market. As we have seen, most professionals are not capable of outguessing the market, and those that do are not normally very interested in telling the media about their thoughts.

What's more, you can normally find an expert somewhere to support any view at all. Perhaps the journalist has a heavy workload and just rang a friend at a bank, arranged to meet for a drink, asked about the market, and relayed this as 'experts say the market is overvalued'.

"The money market predicts rates will rise from 3.5% today to 5% by late next year…The good news is that such predictions are probably wrong… Many analysts see rates reaching no higher than 4.5% in 18 months."

These 'analysts' are a bit like the experts. I would have more faith in the market's view. Those analysts are free to put their money where their mouth is and bet against the market if they want, but I've rarely met any with enough skill or conviction.

"With the euro at $1.25 a sustainable range is $1.22 to $1.28. Upside risks predominate though a short term drop to $1.15 is not out of the question."

This is a bet each way. The easiest forecast to make is something like: if the price doesn't rise, it will fall, or perhaps even stay the same. It's useless.

"The pound will rally to $2.10 before weakening to $1.50 next year."

This is what I call a 'zig-zag' forecast. Not content to just predict the next price move, the guy thinks he can predict the next two moves. He thinks he has the price on a string. A very untrustworthy type of forecast.

"Upward movement in the dollar will depend on whether the Fed lends a hand by signalling the end of rising interest rates."

This is plain wrong. Rising US interest rates are good for the dollar. Sadly, mistakes as simple as this are not uncommon.

"The markets were overheated so a correction was expected."

Hindsight. With comments like these I always wonder who expected the correction. Did they sell at the right time?

"I'm still looking for a positive January for the Australian dollar as it has done very well in four out of five of the last five starts to the year."

Irrelevant. How can anyone print this?

"The market's gone too far."

Often these comments appear after a big move, but as you will see, I am a firm believer that the market often surprises everyone with how far it can go.

"The market's going to 20,000!"

Or to the moon. Beware of the crazy forecaster looking for a publicity stunt. Yes, it does happen. The wildest forecast gets the most press, and fifteen minutes of fame for the forecaster.

So keep a critical mind when you read or hear market comments. Ask yourself these questions:

- Does the commentator have any track record?
- Are they considering all of the factors?
- If they are pointing to influences which have been present for some time, why should they start moving the market now?
- Are they relying on hindsight?
- Are they hedging their bets?

Part of this is to be a sceptic. Who is the writer? Don't listen to ill-informed, ad hoc, one-eyed, overpaid, inexperienced, sensationalist, untested, uncommitted and uninvolved people!

I would have more respect if a commentator was asked something and actually said 'I don't know'. He could then continue 'because of the following...' and you know you're going to get a balanced answer. It's brave to say 'I don't know', especially if you're in a meeting with traders or at a board meeting talking strategy, and everybody wants to hear your opinion. I

try to be disciplined enough to admit that it is just too difficult sometimes to have a view.

As an example, at a Home House function before the Iraq war, Prince Charles asked me what was going to happen to the markets and I said "I don't know, it depends on what happens with Iraq, and you'd probably know more about that than I would!" He agreed – somewhat nervously.

1.9 Understand recent history

If the papers and so-called experts are unreliable, how do you ever learn about markets? The answer is that you should start by trying to understand what's happened in the past. I cannot stress this too strongly. A common mistake of all levels of investors is not doing enough homework. Most of my own time on markets has been investigating how prices have behaved in the past. You cannot hope to predict if you do not understand.

I am not suggesting an enormous amount of research. The effort should be in thinking about how prices have reacted to big picture influences in the past few market cycles. This does not require extensive number crunching or time in the library.

Consider the dollar-euro rate. Before I would ever dare to have a view, I would have to understand where it's been and why. In the last few years, the euro has had a whopping range in value of $0.85 to $1.35. The reasons behind the moves include budget deficits, trade balances, interest rates, economic growth and politics. But these are big picture influences – we don't need to delve into anything too obscure. I will give you more help later with some useful ways to track these things.

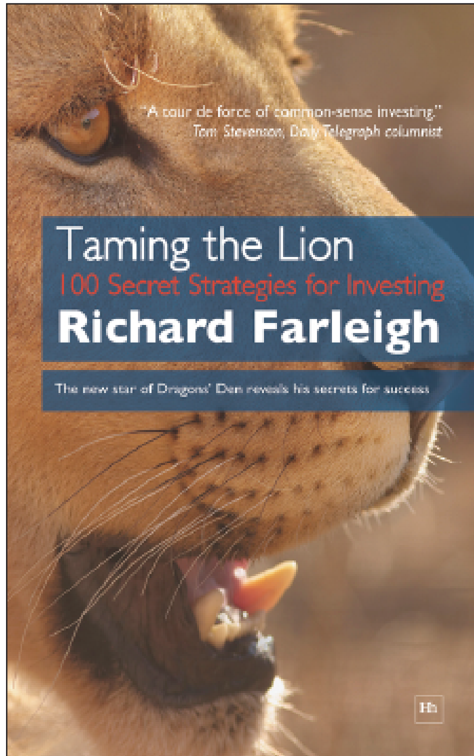
An inexpensive education

When you are looking back at price moves you can also perform a useful training exercise. Try to imagine how you would have played the market in the past at different times based on the news which was available. How would you have performed? Would you have picked the big moves?

Taming the Lion

100 Secret Strategies for Investing

Richard Farleigh



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