Jack Schwager has borne witness to the alternative investment explosion of the last quarter century by interviewing its most successful and colorful participants.

Q & A

JACK SCHWAGER: Chronicling trading excellence

INTERVIEWED BY **DANIEL P. COLLINS**
PHOTOGRAPHY BY **NATHALIE SCHUELLER**

Jack Schwager began his career in markets as a research director for Paine Webber looking into the emerging commodity trading advisor (CTA) universe. His research and writing skills led Schwager to write several technical trading books. But he longed to learn more about what makes successful traders than can be found from a quantitative study and decided to go right to the source by interviewing the most successful traders of the day. Schwager has gone beyond simply telling the stories of successful traders. His knowledge of the space has landed him a position as co-portfolio manager for ADM Investor Services' Diversified Strategies Fund and he has consulted for institutional investors for many years. His early "Market Wizards" not only have told the compelling stories of successful traders, but also have served as inspiration to a generation of new traders, many of whom have taken their place in the roster of market wizards inspired by the stories in the original books. His newest book, "Market Sense and Nonsense," attempts to debunk many of the misconceptions in the investment world. We talk to Schwager about what he has learned interviewing traders over the years.

FUTURES MAGAZINE: Jack, you have had a long, distinguished career in finance but are best known for your "Market Wizards" series of books. What drew you to interview successful traders?

JACK SCHWAGER: The idea came years before the first "Market Wizards" book. I thought it would be a good way to meet these people and it was an interesting project, but I had a day job and I wasn't about to start another book. But I was approached by [a publisher] who said 'we would like to do a series of books and I want you to be the managing editor.' They wanted me to do a bunch of analytical books and I said, 'Thanks, but no thanks. I've done my analytical book, but I have this idea [for a book on traders],' and they said that's great. So that was the catalyst.

FM: There are a lot of successful traders. How do you decide who you will include in your books? Are there any set criteria you create for inclusion?

JS: For the first two books I was looking for a spectacular story. And there were quite a number of those around at the time. Those were in the days where you had (Michael) Marcus, (Bruce) Kovner and Paul Tudor Jones. It was early in their careers; they were not very well known, yet had these spectacular track records. That is what I was looking for in those early books. Right now I am not so much focused on returns, I am looking at return-to-risk as a guideline.

FM: Any second thoughts on profiles?

JS: Oh sure, I have made mistakes. But mistakes

would not be someone like Richard [Dennis] who subsequently had less successful careers. Dennis started with less than $1,000 and turned it into $1 million, I don't really care what happened after that point — that is an accomplishment only a handful of people in the world will ever [achieve]. That was the story. However, I did have people in the books who did do well whose returns I thought were not dependent on the bull market, but in retrospect were dependent on the bull market. So I am not happy with everyone I picked.

FM: Are there certain qualities that you have noticed successful traders tend to have? What are they?

JS: There are. One that is mentioned most often by traders themselves and is a bit of a cliché is discipline. But it is true — all these successful traders are disciplined. Discipline is absolutely essential. Another one high on the list is extreme flexibility and the ability to change your opinion. The really good traders can be wrong on a trade and not only just get out, but also reverse on a dime.

The single most important thing, even before discipline and flexibility, is that they evolve a trading methodology that fits who they are. ... Every person has a different approach [based on] who they are. If they try and trade something that doesn't fit [with who they are], they will go off the rails.

FM: How important is it for you to talk to a manager and have that manager describe where his or her edge comes from, as opposed to simply examining a track record and looking over offering material?

JS: It is absolutely critical. Track records often don't have the whole story. In many cases you can't evaluate a manager based on a track record. Certainly for a majority of the hedge fund world, the risks that are inherent in those strategies are not the types of risk that manifest themselves regularly in their track record. There is sporadic risk. Like trying to evaluate flood risk in an area that hasn't had a flood in the period that you are looking at. You say, 'Oh, there is no problem here.' Well yes, there is, you just don't have enough years.

FM: But you do know an option writer has risk even without a drawdown. I want to know what you want to hear from a manager.

JS: When I am talking to them, I am looking for an understanding of what they are doing, an understanding of where the potential edge might come from, what risks are being taken to get that return, is it different from what other people are doing and if there is a [good] reason to believe that they have a shot at doing better than average. You just make your best qualitative assessment. Is it perfect? Is it very reliable? No. Does it give you a little edge? Hopefully.

FM: Your first "Market Wizards" book came out 25 years ago; what changes have you seen from both the investor and manager perspective? What have been the changes in the traditional and alternative market space?

JS: In terms of the global macro CTA world, the very [large returns] you don't see anymore. Smart money is a bigger percent of the pie, so it becomes a lot harder. The scope of what is possible is not as great as it was. Markets always are changing. Currency markets were hardly a factor back then. Hedge funds as a whole were much smaller, but the general principles of trading haven't changed.

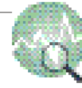
FM: Haven't the expectations changed? Managers aren't shooting for huge returns like they used to.

JS: What is possible has gone down, [especially] with the zero interest rate environment. If you have 6% or 7% interest, that adds to your return; so the zero interest rate counts against your return. You look at the long-term trend-followers who have been around for a while, those that started in the '70s and '80s and even early '90s, had one type of return, and then if you look from [the] mid-'90s on it has been a different story. Trend-following still works but it certainly doesn't deliver the return-to-risk as it did in the early days.

What a manger targets is totally irrelevant. I say that as an allocator. I don't care if a manager is targeting 5%, 10%, 20%, 40%, whatever. If you invest in a managed account, you are going to decide what notionalization you are going to use.

FM: You most often write about hedge funds and CTAs. Do you consider managed futures a hedge fund subset or a completely different asset class?

JS: I consider it kind of a subset, but there are some very important distinctions. One of them is liquidity. It is the most liquid part of the investment universe. That also means something else very important. It means that CTAs are the only group that is probably immune from correlations going to 1. At the end of 2008, you had all these strategies, which at times might be significantly uncorrelated, yet during the crisis of 2008 and



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2009 start to behave extremely similarly. That is true because everybody is on the same side of the fence; everyone is trying to get out.

FM: Your new book attempts to debunk the Efficient Market Hypothesis. Why do you think this has persisted despite all the evidence to the contrary?

JS: That is easy to answer. There is one great thing about the Efficent Market Hypothesis and underlying assumption of normal distributions [and] the whole academic finance structure; it allows you to quantify, it allows you to give precise answers. It may be the wrong answer, but it is precise. If you take away that normal distribution and [the notion] that markets are efficient, then you can't really answer the questions of 'How do I allocate my portfolio? What percent should I put in stock and bonds?' I would argue that the answer is not only wrong, but it may be worse than random. My view of markets is that they are influenced by fundamentals, and there are times when the markets will act [efficiently], but the really big moves come where emotions play a very large role. We call those big moves bubbles and the collapse of bubbles. That model describes the world accurately. But as I like to say, market moves begin on fundamentals and end on emotion.

FM: What is your opinion of the trend toward managed futures? Will it become normal for retail investors to have an allocation to trend-following strategies in their portfolios?

JS: I have mixed feelings. On the positive side, it is preposterous to think that mutual funds of stocks are OK for regular people and conservative investments whereas mutual funds of CTAs are risky and shouldn't be allowed for average investors. It is absurd because if you go by track records, returns are probably similar and they are much less volatile and risky in the CTA world. There is a complete bias unsubstantiated by any [analysis], and that flies in the face empirical evidence. However, here is the problem. If too much of this goes on, the traditional investment world is too large and the industry can't absorb it. If it becomes successful, it is going to kill the industry. Returns will be driven down where there just won't be satisfactory [levels]. The biggest risk to the industry is if it becomes too popular.

FM: But most of the allocations to managed futures are concentrated in a few institutional managers, like Winton. Isn't there a lot of capacity in emerging and non-institutional CTAs?

JS: Yes, that's an old problem. I consult as a portfolio manager and the managers I recommend are smaller managers; we have very few large managers. Ironically, the one large manager we have has by far been our worst performer. You're better off [investing] in smaller managers. It is very difficult for these giants to deliver great returns to risk. Also, a lot of the big guys are very correlated. So, for those reasons, I personally gravitate away from the larger managers.

FM: After two tough years for CTAs, we are hearing once again that trend-following is dead. Do you think the markets have changed in a material way or has it just been a poor environment that will change because everything in trading changes?

JS: The markets have changed. You have a tremendous amount — a much larger amount — of money using trend-following techniques than what was the case earlier. The fact that there is so much money in this strategy inevitably hurts returns. That makes trend-following more difficult. However, there are some very strong fundamental reasons why trends should exist. The key reason is the way markets work fundamentally. Central banks [and governments] make major changes in financial policy that will [alter] the direction of interest rates and currencies. Those policy changes that are supported by action will cause trends and will cause trends to persist. Commodities aren't [affected] by government as much, but you have [cycles of] surpluses [and shortages]... so you get trends. However, if too many people are trying to exploit those trends, then those trends become much choppier. It doesn't make [them] disappear, but it makes them much more difficult to capture.

FM: What is your ideal portfolio allocation?

JS: I guess that would change over any given period of time. A diversified portfolio of CTAs should be a good part of it. A good sum of it should include some hedge fund investments and, if you wait for periods where equity markets have drawdowns, establishing long positions in equities would be OK, but not after a [strong up move]. F

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FM: You wouldn't have a certain percentage always dedicated to equities?

JS: No, I don't believe in having a certain percentage [permanently] allocated to equities. I believe in allocating to equities when they are doing terrible and allocating to CTAs/hedge funds [strategically]. I certainly don't believe in any balanced portfolio type of mechanism or guideline. That could be dangerous. Any investment I might have [right now] would not have a long fixed income element. I could be wrong, but from a long-term return-to-risk, there is much more risk than return in being long [bonds] than being short or flat. Although it is traditional to have 40% of your portfolio in bonds, it could be a very bad thing to have. That falls under the realm of a market forecast; let me make clear that I don't consider myself a market wizard.

FM: A point I have made over the years is that trend-following is a pretty broad description of a group of approaches used to find an edge in futures markets, and there is more diversity in that space than many people realize. Do you agree?

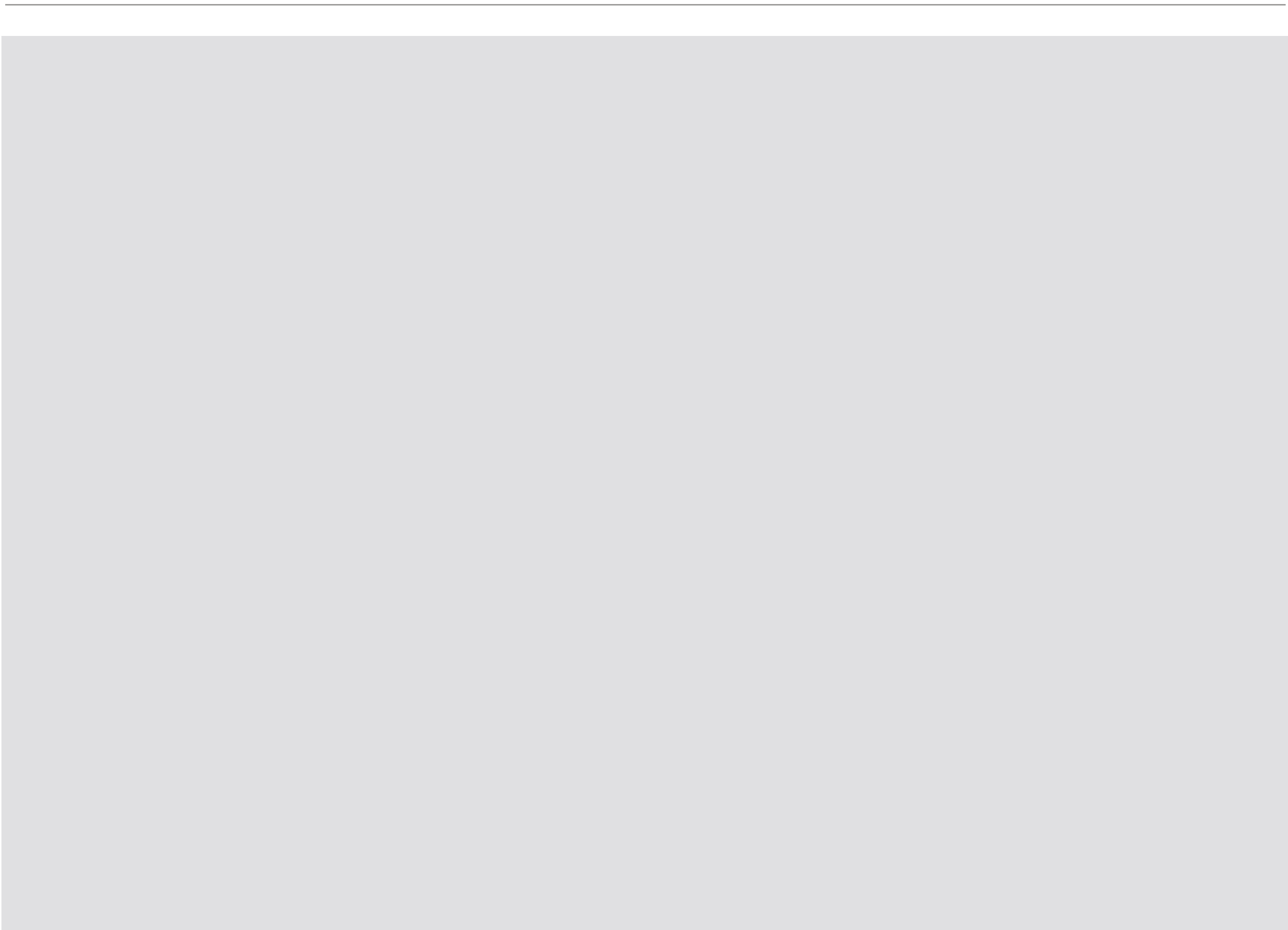
JS: Actually, I would almost disagree. If you look at different strategies, one that has the most correlation among managers is trend-following. Trend-followers as a group correlate with each other in bull markets, bear markets, sideways markets; year in, year out there is a much more stable correlation. If you took some other strategy like merger arb or convertible arb and looked at them, there [would] be periods where they will be correlated to each other and periods when they [aren't as correlated]. But with trend-followers the correlation is very stable.

FM: There is a tendency in professional investing to try and benchmark everything and set a beta for various types of investments. Although there are better and worse environments for various strategies, this approach tends to eliminate qualitative difference among managers. Is this a mistake?

JS: The CTA space becomes much more differentiated as people like myself look to find strategies that are uncorrelated to trend-following. It has become much more differentiated, and there are a lot of strategies out there other than trend-following. In my own portfolio, I make up my own sub-categories: Fundamental systematic, trend-following, fundamental discretionary, technical discretionary spreads, mean reversion, intraday, systematic vol arb, pattern recognition, short-term systematic; all of those are different from trend-following.

FM: How have your professional investments performed?

JS: I have a number of projects. The main one right now is acting as a portfolio manager for ADM. I don't talk about returns and we just started in the middle of last year. It is basically a fund of managed accounts of futures or FX managers. The number is in the 20s and the allocation process is risk-based.



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