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Market basics: Experts explain trend identification tactics

Philosopher Walter once said, "When it is a question of money, everyone is of the same region." To discuss the basics of money making, trading maxims and overall philosophy behind global trading on CNBC-TV18's special RD 360, financial expert Ramesh Damani caught up with trading experts Lashit Sanghvi director at Alchemy Capital Management and trader Atul Suri. These two veterans have seen a ring side view of many a boom and a burst, seen greed and fear as they have navigated the wilds of the street with exceptional agility.

Below is a verbatim transcript of the exclusive interview on CNBC-TV18. Also watch the accompanying videos.

Q: Most of these trading rules come from a guy called Jesse Livermore. Give me a 30 second bio on him?

Sanghvi: Jesse Livermore, popularly known as boy plunger, started trading at the age of 14 in bucket shop. It's Dabba trading, where you don't buy and sell actual stocks. He made so much money in two years that majority of the dabba shops banned him from trading.

Q: This is in the 1920?

Sanghvi: Little earlier to that, 1915. Graduated to Wall Street and adapted to legitimate markets. He wrote a very remarkable book called 'Reminiscences of a Stock Operator'. He spelled down brilliant principles and framework of trading, which is equally important and useful for any trader even today.

Q: It is a classic and a must read if you are a trader. Let me start with some of the maxims that he wrote and the one that always struck me and that he would pay importance to. Well you know this is a bull market. Is the sense of money making simple is and hidden in it?

Sanghvi: What he is trying to say is basically you have to get the broad market trend first and stick to a position with conviction. You seldom make sizable money by trading in and out. It is when you hold on to your position and scale up your position in right manner; you get the macro broad trend right. For example, I would say in 1998 all those who identified tech stocks like Infosys, Satyam made gains at least 30-40 times bare minimum over a period of 2-3 years gained.

Q: Rs 30 crore IPO to Rs 1 lakh crore.

Sanghvi: Absolutely unbelievable, but that money is made only by sticking to your position. Your try and buy in and out, get some minor fluctuations that are good for bread butter.

Q: He also said you don't get rich taking a 4 point profit in a bull market?

Sanghvi: Precisely. You get bread butter out of it and I think it is an illusion or perception that day trading can make some money but ultimately you end up losing. Big money or sizable money is made when you make significant position and play through the trend.

Q: Get the trend right.

Sanghvi: Absolutely.

Q: That is true of trend of a bull market or a bear market?

Sanghvi: Either which way. It could be a trend like bull market in which after the trend bursts, all the tech stock come down to the lows.

Q: In fact Infosys was at Rs 13,000 to Rs 2,000?

Sanghvi: Infosys is a brilliant company like software solution. It came back where it started, unbelievably, it started 100 times and it came down.

Q: They always say bull market knows no top, bear market knows bottoms.

Sanghvi: Absolutely.

Q: You are a great fan of Ed Seykota also immortalize in a book, Market Wizards. Give me a bio on him?

Suri: Ed Seykota is essentially is engineer from MIT. So he has a science background and is one of the early guys to use computers in a stock market. So he went into systemize trading where all his principles and rules were ultimately coded so you need a very logical thought process for trading and the beauty is that he just does not focus on the system. He went on in life and realized that the system itself is not the most important thing. The most important thing is the human, the physiology that goes.

Q: But one of his most famous rules to take off from what Jesse Livermore immortalized is, he said very simply that the trend is your friend until it bends. Explain it to me?

Suri: That is exactly what it is all about the primary trend. If you get the primary call in the market and fortunately in a country India, if you notice, in the years gone by you get this two years kind of moves whether it was 1998 to 2000, 2000 to 2002, 2003 to all the way to 2008 and then again a fall. You get this very secular kind of moves. In India, I guess the big call has been that if you got this primary trends right you make a lot of money.

Just to give you an example when we started this last bull market in 2009, the early breakouts that I saw were in the auto space and first stock to touch lifetime high was Hero Honda. I was looking at

Bajaj Auto at Rs 350 and it was like a good looking chart. I went up and met a buddy and said I think this is really good, it has moved up so what's new about it. It just went from Rs 350 to almost Rs 1650-1660 so you got a five baggier in a front line F&O stock. What was it? It was the trend and the beautiful thing about this is that this ride is only possible if you remember the second line which is until the end when it bends. So if you are trying to get the top and trying to sell it at every top, make sure that you are never going to ride it. You will never get out.

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Q: The stock goes up, doubles up, should we try to find the top? What is the good trade over there?

Suri: I don't think so; I think that as you said that it can keep doubling up, just as in a down market. However, in the IT boom, we saw some stocks go to zero almost.

Q: Went down 50 % and then 50% back and then 50 true.

Suri: So actually, atomic destruction, where like it's this nucleus, they break into half and half and you have a atomic explosion, so that's what happens with stocks, stocks don't go to infinity, but the best way for the trend trader is to really assume that they go to infinity. Keep a stop loss, which may be a percentage or whatever tool you have, whatever is good for your portfolio.

Q: A good trader doesn't try to find the top; he waits for the stock to correct and then tries to see if it goes back to the top?

Suri: Exactly, it's about the basic principles of markets like the Dow principle, making higher bottoms and higher tops. There are so many tools, you just cannot beat the performance and the basic rule that it's like steps; if you are climbing and a next step is higher, then you know you are climbing up, but the moment the steps get lower, you know you are walking down and you know that the up flight has handed, so I think that's what the way the markets are, that's the way the stocks are and that's what the trend is all about.

Q: Talking about stocks and speculation, one thing that grabbed me when I was reading his book for the first time and I have read it personally 10 times myself is that of all the speculative blunders there is none greater than trying to average a losing game, always sell what shows you a loss and always keep what shows you a profit? Explain that in our context?

Sanghvi: Actually masses do exactly reverse and which is actually, which leads to multiple losses.

Q: This trading you are talking, not the industry?

Sanghvi: Trading, I am talking about purely trading. Only makes mistakes, which are affordable. You cut down your losses very quickly, continue with your profits, pyramid your profits, whereas human nature is whereby you are trying to say okay, I have made some money, let me take, but in eternal hope keep averaging out your current position like investments and that's what leads to problems. It's very true for a successful trader to continue with the favorite position, pyramid if required, but it is also important to cut down the losses very quickly.

Suri: Geniuses kept averaging and then there you see the biggest bankruptcies, this is why they failed.

Damani: Right, they kept averaging on losing game. In one of the previous episodes of my show, one of experts said that *satta kabhi cheque book se nahi hota, slip book se hota hai* (Gambling happens because of the slip book and not the cheque book), so those were the great maxes.

Q: It is said, "The highest profits are made in trades that show a profit from the get go"?

Sanghvi: In 2008, Satyam went bust. So first when I heard it was more like it can't be true; how can a company go bust? Then actually the company wrote a letter and all the cards were open.

Q: And the stocks were already down from 100 to 80?

Sanghvi: Absolutely. And it was an all known facts. At Rs 80 a share, I started selling.

Q: After it was down 20%?

Sanghvi: Yes, because basically the company is saying we are bust; we don't have money to pay salaries. And this is a stock where you can sell as much as you want; it is extremely liquid and that day had exceptional volume also.

Now in this kind of situation when you sell and immediately in 5-10 minutes you see a downtick, you can sell more, you can sell as much as you know because in your mind you are very clear that, trend is your friend, it is giving you the favorable outcomes and if the company is going to go bust the stock has a long way to go.

Q: Bust means zero in effect?

Sanghvi: Technically, but it doesn't happen that way. So in two days it was at Rs 10 per share. Its like the sweetest trade, you can bet big, you can keep averaging in your favoured position till a certain extent. It is like akin to putting a hot knife through butter.

Q: It's psychologically hard to do because the stock was already down 20%.

Sanghvi: That's where your convection comes, your courage comes and you can't fear your profits. Till market shows you a trend you be with it, when market somewhere starts rebounding and when it rebounds, it rebounds from Rs 10, it will rebound to Rs 12-13 which is also good 20% for the bottom.

But for the person who has sold at Rs 80 or at an average of Rs 65 or Rs 68, it's a huge amount of money, it's the sweetest money which I thought I am starting my trade with Rs 5-10 stop loss. It resulted in some Rs 70 a share profit.

Q: The big trend was made by a big swing; you understood it was going bust?

Sanghvi: Absolutely.

Q: The flip side is that markets are made of two kinds of people, so difference of opinions happens. Someone went long on Satyam when Lashit was shorting it and he was advised that the elements of good trading are: cutting losses, cutting losses and cutting losses. If you follow these three rules, you have a chance? Explain that.

Suri: Absolutely right. In this market, the success rate is not very high. You will land up many loosing between a few very big winnings and if you do not cut your losses in that rest assure that you will be sold out.

Like there is a very great hedge fund manager right now, Steven Cohen and they analysed his trades and he has got a great strike rate. He only gets 60% of his trades right. So 4 out of 10 trades are wrong and this is for someone who he is a master, who is very good at it. And if you do not cut those 4 trades sooner or later you are going to be in the wrong side of Satyam and rest assure that the damage is going to be so much that you will be wiped out. And people have been getting out whether it's a hedge fund like Amaranth, the famous natural gas trade they could not exit their positions. So the first loss is the easiest.

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Q: Give me an example of something, you took a loss and you are so happy that you took it.

Suri: That's something that made an impression in my life; I fear not having a stop loss was the trade of Mastek. The 2000 boom had happened and I made my money on Mastek on the upside and it connected. And I had just entered the market, arrogance, the great big story. It was like Mastek had become cheap, it had become half and I got into the trade and I saw it going for three consecutive down circuits, you had 16% circuits. When I had computed in that small trade, I had given away my major part of the profits. So whenever I see the downtick or whatever somewhere behind me that Mastek comes into my mind. That's a trade of course I never do it now. I never trade Mastek. But that has really taught me the thing of a stop loss.

Q: Markets are never wrong, opinions are?

Sanghvi: Obviously, in fact markets start showing the way that they want to behave or the trend which is there. Seldom do you realise at that point of time or it is we who don't see them clearly. It’s only with passage of time or great price damage or appreciation when you realise this is what the reasons can be.

Q: Prices move, reasons follow?

Sanghvi: Absolutely.

Q: Are great traders born or are they made?

Sanghvi: Nobody can teach you trading. You have to learn, you have to have inherent characteristic of a trader where you have to have humanity and humbleness. You can't have ego. You have to be very nimble-footed, strong stomach and also very stringent discipline in terms of how you trade, in terms of how you pyramid, how you stop your losses, how don you scale up your positions, when to take, how much stop loss to put.

Q: Either you are hard wired with it or you are not?

Sanghvi: Absolutely.

Q: What is your view?

Suri: I think otherwise because I have been influenced by this famous turtle trading experiment that happened in the US.

Q: Only two of them became great?

Suri: I guess that is. I guess he went on to prove a point that if you really follow principles with discipline, you can create a successful method. I would also swing around to agree with him some respect that in spite of having all the discipline and tools yet you realise that after people left the turtle trading experiment very few of them succeeded on their own. And, that's where it comes in is that you have to have that hunger to make money. You really get what the market gives you.

Q: Ed Seykota has quoted a line—Win or loose, everybody gets what they want out of the markets. Some people like to loose so they win by loosing money—it seems bizarre, but you get want you want?

Suri: Absolutely. You can again teach people rules, it may be 99% of the thing but that 1% that there is your in bond desire.

Sanghvi: You yourself.

Suri: For all great traders one thing I have seen is common—passion to make money, make money not in the vulgar sense as the movies like to portray but it is a game, it is a passion.

Q: How you keep score?

Suri: Exactly. Anything in life you keep a score on.

Q: What do you want to tell the other children looking at the market dream big clearly?

Sanghvi: Dream big. At the same time follow up in actions with a great amount of diligence. It is a lot of hard work. There is no get quick rich kind of thing in trading and ultimately make mistakes which you can afford. Because in trading you have to be on the table. If you are out of the table anyway the game is over.

Q: How do you spot a good trader?

Sanghvi: Ability to read prices, correlate price movements with external opportunity or environment. Also understand the crowd physiology in terms of market behaviour.

Another very important thing for trading is sheer experience. It's not an overnight affair; somebody cannot come and straight away become a good trader because it needs serious amount of experience and experience of yourself—how you behave in different situations because in trading you are your own biggest enemy; your own strength and your own weakness.

Q: Buffett was right when others are greedy, be fearful and others are fearful, be greedy.

Sanghvi: Absolutely.

Q: What are the qualities that you look for in a great trader?

Suri: I think one of the things is desire to learn, to grow because the market is teaching you and humbling you, however great you are. Everyday it is teaching you new. The moment you shut the door and say listen, "I know it all, I am the master", the market is going to humble you.

So, however great a trader is, he will always ask "How does the market look" (market kya lagata hai). It is such a habit in the market, the moment you meet anybody, anywhere at a wedding anywhere they would ask, "market kya lagata hai". It is just this desire to know. That is one thing and second is lack of ego; the same principle of cutting your losses. However great you are, however good your last trade is, however much money you have the next trade has the potential to wipe you out.

Q: Take the losses you can afford?

Suri: Absolutely.