Bill Lipschutz: The Sultan of Currencies

Quick, what is the world's largest financial market? Stocks? No, not even if you aggregate all the world's equity markets. Of course, it must be bonds. Just think of the huge government debt that has been generated worldwide. Good guess, but wrong again, even if you combine all the world's fixed-income markets. The correct answer is currencies. In the scope of all financial trading, stocks and bonds are peanuts compared with currencies.

It is estimated that, on average, $1 trillion is traded each day in the world currency markets. The vast majority of this currency trading does not take place on any organized exchange but rather is transacted in the interbank currency market. The interbank currency market is a twenty-four-hour market, which literally follows the sun around the world, moving from banking centers of the United States, to Australia, to the Far East, to Europe, and finally back to the United States. The market exists to fill the needs of companies seeking to hedge exchange risk in a world of rapidly fluctuating currency values, but speculators also participate in the interbank currency market in an effort to profit from their expectations regarding shifts in exchange rates.

In this huge market, there has been only a handful of high-stakes players. Ironically, although these traders sometimes take positions measured in billions of dollars-yes, billions-they are virtually unknown to most of me financial community, let alone the public. Bill Lipschutz is one of these traders.

The interviews I held with Lipschutz were conducted in two marathon sessions at his apartment. Lipschutz has market monitor screens everywhere. Of course, there is the large TV monitor in the living room, receiving a feed of currency quotes. There are also quote screens in his office, the kitchen, and near the side of his bed, so that he can roll over in his sleep and check the quotes-as indeed he does regularly (since some of the most active periods in the market occur during the U.S. nighttime hours). In fact, you can't even take a leak without literally running into a quote screen (there is one conveniently located, somewhat tongue in cheek, at standing height in the bathroom). This fellow obviously takes his trading very seriously.

I had first contacted Bill Lipschutz through a public relations agent, Tom Walek. Yes, a public relations agent for a trader sounds rather odd. In fact, this is particularly true for Lipschutz, who had managed quite deliberately to maintain virtually total public anonymity for his entire career despite his huge trades. However, after having spent eight years as Salomon Brothers' largest and most successful currency trader, Lipschutz had just left the firm to start his own management company to trade currencies (initially as a subsidiary of Merrill Lynch; later, the company evolved into a completely independent venture, Rowayton Capital Management). It was this project that required the public relations support. Anyway, after Walek discussed my interview proposal with Lipschutz, he called to tell me that Bill first wanted an informal meeting so that he could see if it "felt right."

We met at a Soho bar, and after downing several French beers (no joke, the French actually produce some excellent beers) Lipschutz said, "I think you'll find the story of how, in less than a decade, Salomon Brothers grew from a zero presence in currencies to becoming perhaps the world's largest player in the currency market an interesting tale." Besides feeling a sense of relief, since that comment obviously reflected a consent to the interview, his statement certainly whetted my appetite.

In our first meeting at his apartment, with my tape recorders whirring, I said, "OK, tell me the story of Salomon's spectacular growth as a major trading entity in the world currency markets." I sat back, anticipating a lengthy response full of wonderful anecdotes and insights.

Lipschutz answered, "The currency options market, Salomon's currency options department, and I all started at the same time and grew and prospered simultaneously."

"And ...," I said, prompting him to continue. He rephrased the same response he had just given.

"Yes," I said, "that's a very interesting coincidence, but could you fill in the details? How about some specific stories?" He responded again with generalizations. My hopes for the interview went into a rapid nosedive.

I've done interviews that I knew were dead in the water after the first hour and have ended up ditching the results afterwards. However, this interview was different. Although I felt that I was getting very little useful material during the first one or two hours of our conversation, I sensed there was something there. This was not a dry well; I just had to dig deeper.

After the first few hours, we started to connect belter and Lipschutz began relating specific stories regarding his trading experiences. These make up the core of the following interview.

As mentioned earlier, the large TV screen in Lipschutz's living room is normally tuned to a currency quote display, with a Reuters news feed mnning across the bottom. Although Lipschutz seemed to be paying full attention to our conversation, on some level he was obviously watching the screen. At one point, the Australian dollar was in the midst of a precipitous decline following some disastrously negative comments made by the Australian finance minister. Although the market was in a virtual free-fall, Lipschutz felt the sell-off was overdone and interrupted our interview to call in some orders. "Nothing big," he said. "I'm just trying to buy twenty [$20 million Australian, that is]." Immediately afterward, the Australian dollar started to trade higher and continued to move up throughout the rest of the evening. Lipschutz didn't get a fill, however, because he had entered his order at a limit | price just a hair below where the market was trading, and the market "- never traded lower. "Missing an opportunity is as bad as being on the wrong side of a trade," he said.

During our second interview, Lipschutz wanted to short the Deutsche mark and was waiting for a small bounce to sell. When noticing that the mark had started to move lower instead, he said, "It looks like I'm going to miss the trade."

'That sounds just like last week when you missed getting long the Australian dollar by using a limit order," I said. "If you feel that strongly," I asked, "why don't you just sell the Deutsche mark at the market?"

"What! And pay the bid/ask spread?" Bill exclaimed. I wasn't sure whether he was serious or joking-or perhaps some combination of the two. (Incidentally, the Deutsche mark kept going lower.)

Our interviews were conducted after U.S. market hours, but, since the currency markets never close, Lipschutz, apparently, never stops trading. However, despite his admitted obsession with the markets and trading, Lipschutz appeared very relaxed. I wouldn't even have known that he was watching the markets had he not occasionally made references to price movements and placed orders over the phone.

==== What happened to architecture? ====

What happened to *architecture?*

==== Well, I had heard that you have a degree in architecture. How is it that you ended up as a trader? ====

While I was enrolled in the architectural program at Comell, my grandmother died and left me a portfolio of a hundred different stocks with a total value of $12,000, which I liquidated at great cost because all the positions were odd lots. The proceeds provided me with risk capital. I found myself using more and more of my time playing around with the stock market. It wasn't that I got less interested in architecture, I just became a lot more interested in trading.

Also, architecture is very much an Old World profession. There is a long apprenticeship-three years in this country-before you can take your licensing exam. Then you spend many more years as a draftsman. It takes a long time before you get to me point where you have control over the design process.

==== Did you get your degree eventually? ====

Yes, of course. Actually, I got two degrees. The full-time architectural program took five years. It was not unusual for architectural students to also enroll in other courses and take longer to finish their degree. I ended up taking a lot of business courses and also earned an M.B.A.

==== What happened after you graduated Cornell? Did you get a job related to architecture? ====

No, I never practiced as an architect because of the long apprenticeship process I just explained. I went directly to work for Salomon.

==== How did you get that job? ====

It's typical for students in the M.B.A. program to get business-related summer jobs. In the summer of 1981 I got a job at Salomon Brothers. By that time, I was trading stock options very actively for my own account.

==== Was this the account you started with the $12,000 your grandmother left you? ====

Yes, and by this time I had built it up a bit.

==== What did you know about stock options when you started trading? ====

I didn't know a whole lot.

==== Then on what basis did you make your trading decisions? ====

I tried to read everything I could on the subject. I spent a lot of time in the library reading annual company reports. I became an avid reader of the various financial periodicals such as *The Economist, Barron 's,* and *Value Line.*

I also began to watch the stock tape on cable. Because Ithaca, New York, is surrounded by mountains, it has particularly poor television reception. As a result, it was one of the first places in the country to get

cable TV in the early 1970s. One of the channels had a fifteen-minute delayed stock tape. I spent many hours watching the tape and, over time, I seemed to develop a feel for the price action.

==== Was that when you decided to become a trader? ====

I can't remember making any conscious decision, "I want to be a trader;

I don't want to be an architect." It was a gradual process. Trading literally took over my life.

==== Was the Salomon summer job related to trading? ====

My wife and I met while I was attending Comell. She's very aggressive and has a very strong economics background. The previous summer she had managed to get a job working for Dr. Henry Kaufman [a world-renowned economist] in the bond research department. I subsequently met her immediate superior, who also happened to be a Comell alumnus. He arranged for me to interview with Henry Kaufman for the same position my wife had held (by this time, she had graduated and had a •full-time job).

Ironically, around the same time, Salomon Brothers sent a representative to Comell to do recruiting. I was invited to come to New York to interview for their summer sales and trading intern program. I was interviewed by Sidney Gold, the head of Salomon's proprietary equity options desk. Sidney is a very high-strung

guy who speaks very, very fast.

He took me into an office that had a glass wall facing out onto a large trading room, with a view of an electronic tape running across the wall. I sat with my back to the tape, and the whole time he was interviewing me, he was also watching the tape. He started firing questions at me, one after die other. Here I am, a college kid, wearing a suit and tie for the first time in my first formal interview, and I had no idea what to make of all of this. I answered each of his questions slowly and deliberately.

After about ten minutes of this question-and-answer process, he stops abruptly, looks me straight in the eye, and says, "OK, forget all this bullshit. So you want to be a trader. Every fucking guy comes here and tells me he wants to be a trader. You said you're trading your own account. What stocks are you trading?"

"I've been pretty involved in Exxon recently," I reply.

He snaps back, "I don't know that stock. Give me another one."

"I've also been pretty involved in 3M," I answer.

"I don't know that one either," he shoots back. "Give me another one."

I answer, "U.S. Steel."

"U.S. Steel. I know Steel. Where is it trading?"

"It closed last night at 30 1/2."

"It just went across the board at 5/8," he says. "Where did it break out from?" he asks.

"Twenty-eight," I answer.

He fires right back, "And where did it break out from before that?"

"Well, that must have been over three years ago!" I exclaim, somewhat startled at the question. "I believe it broke out from about the 18 level."

At that point, he slows down, stops looking at the tape, and says, "I want you to work for me." That was the end of the interview.

A few weeks later, I received a call from the fellow who ran Salomon's recruiting program. He said, "We have a bit of a problem. Sidney Gold wants to hire you, but Kaufman also wants you to work for him. So we worked out an arrangement where you'll split your time between the two." I ended up working the first half of the summer doing research for Eh-. Kaufman and the second half working on the options trading desk.

At the end of the summer, Sidney offered me a job. Since I still had one semester left in business school and also had to finish my thesis for my architectural degree, I arranged to work for Sidney during the fall semester, with the understanding that I would return to school in the spring.

==== Did the job working on the equity options desk prove valuable in terms of learning how to trade options? ====

The job was certainly helpful in terms of overall trading experience, but you have to understand that, at the time, equity options trading at Salomon was highly nonquantitative. In fact, when I think back on it now, it seems almost amazing, but I don't believe anybody there even knew what the Black-Scholes model was [the standard option pricing model]. Sidney would come in on Monday morning and say, "I went to buy a car this weekend and the Chevrolet showroom was packed. Let's buy GM calls." That type of stuff.

I remember one trader pulling me aside one day and saying, "Look, I don't know what Sidney is teaching you, but let me tell you everything you need to know about options. You like 'em, you buy calls. You don't like 'em, you buy puts."

==== In other words, they were basically trading options as a leveraged outright position. ====

That's exactly right. But that whole trading approach actually fit very well with my own tape-reading type of experience.

==== Did you return to the equity options department when you finished Cornell? ====

I worked there at the beginning of the summer, but then I went into the Salomon training program, which is something that every new hire does. The great thing about the Salomon training course is that you get exposed to all the key people in the Firm. All the big names at Salomon came in, told their story, and in essence delivered their persona. You were indoctrinated into Salomon Brothers, and me culture was passed on. Having spent my entire career at Salomon, I feel very strongly that it was important for the culture to be passed on.

In the later`s 1980s, a lot of that culture was lost. The programs got too large. When I started at Salomon, there was one program of 120 people each year; by the late 1980s, there were two programs with 250 people apiece- The trainees also seemed to come from more of the same mold, whereas in the early 1980s there appeared to be a greater willingness to hire a few wild-card candidates.

==== What did you get out of the Salomon training course besides being indoctrinated into the culture? ====

That was what I got out of it.

==== It doesn't sound like very much. Was there more to it? ====

No, that was a tremendous amount. Clearly you have never worked for Salomon. The company is all about the culture of Salomon Brothers.

==== OK, tell me about the culture of Salomon Brothers. ====

Salomon Brothers was a firm that was almost solely involved in proprietary trading and for years was run by a handful of very strong, charismatic individuals. They were street fighters who were betting their own money and who really understood what it meant to take risk. It was all about personalities, guts, insight, and honesty and integrity beyond any shadow of a doubt.* Salomon was an institution. There was virtually no turnover of key personnel at the firm- The chairman, John Gutfreund, had a desk on the trading floor that he sat at every day. In my nine years at Salomon, I never sat more than twenty feet away from him.

I remember my first conversation with John Gutfreund. I had been with the firm as a full-time employee for less than a year. You have to picture the scene. It was the early evening of July 3. The Salomon trading floor is a huge, two-story space-at one time it was the largest trading floor in the world. The twilight colors of the fading sunlight were flooding through the huge glass windows. Because of the approaching holiday, the entire floor was completely abandoned except for John Gutfreund and myself.

I heard him call, "Bill, Bill." I had no idea why he would even know my name, but that was the kind of place Salomon was. I was wrapped up in what I was doing, and I suddenly realized that he was calling me. I walked over to his desk and said, "Yes, Sir." He looked at me and asked, "Where did the franc close?" Racing through my mind are all the possible reasons he might be asking me this question in this very scripted scenario. I looked at him and asked, "Which one, Swiss franc or French franc?"

John Gutfreund is a man who exudes power. He is very charismatic and you can almost feel the aura around him. He didn't hesitate, and looked straight at me and said, "Both." So I gave him both quotes in a voice that was probably one octave higher than normal.

Note: //This interview was conducted several months prior to the government bond-buying scandal that rocked Salomon. Following this development, I asked Lipschutz if he still wished to maintain the terms fwnesty and integrity in his description of Salomon, as the words now had an ironic ring in light of the latest revelations. Lipschutz, however, felt strongly about maintaining his original description, as he believed it reflected his true feelings. Queried about how he reconciled this image of integrity with the apparent ethical lapses in the bidding procedures at several government bond auctions, he replied, "I believe it was more a matter of ego on the part of a single individual, which ran counter to the qualities embodied by Gutfreuod and me firm."//

A little over a year later on another summer day, the same scene is virtually repeated. The light of the setting sun is streaming into the trading room, and John Gutfreund and I are nearly the only two people left. Again, I hear a voice behind me, "Bill, Bill."

I am struck by the deja vu quality of the moment. I walk over and say, "Yes. Sir."

"Where did the franc close?" he asks.

"Which one?" I ask. "The Swiss or the French?"

Without missing a beat, and without showing any trace of a smile, he looks straight at me and says, "Belgian."

Here's a guy who is chairman of Salomon Brothers, which in those years was probably the most powerful firm on the street, while I am a nobody trainee. It has been a year since that first encounter, and he has the presence of mind and the interest to set me up like that. As the years went by, and I got to know him better through more contact, I realized that he was fully aware of the impact that conversation would have on me. Here we are talking about it nearly ten years later, and I remember every word of that conversation. He had that effect on people. He would very often have conversations with trainees and support people.

==== Was Gutfreund a trader himself? ====

John came up through the ranks as a trader. When he was chairman, he spent his day on the trading floor to see what was going on. We always said that John could smell death at a hundred paces. He didn't need to know what your position was to know what your position was, or how it was going. He could tell the state of your equity by the amount of anxiety he saw in your face.

Salomon Brothers was a culture like no other. People often spoke of Salomon's appetite for risk. It wasn't that the company was a risk-seeking firm, but it was certainly a firm that was comfortable with risk or with losing money, as long as the trade idea made sense.

==== How was it that you ended up in currencies after the training session was over as opposed to going back to equities? ====

Actually, I wanted to go back to equities, but one of the senior people in the department took me aside and said, "You're much too quantitative. You don't need to be down here in equities." He talked me into going into this new department that was being formed: foreign exchange. I was one of the more highly thought-of trainees, and at the end of the session, I was recruited by several departments, including the currency department, which was just being formed.

==== How did you choose the currency department? ====

I wanted a trading position, and I got along well with the people. However, I had a lot less choice than I might have been led to believe at the time.

==== What do you mean? ====

You get recruited, do your lobbying, and pick your choices, but by the end of the day, the powers that be get to move the chess pieces and decide where they want you placed.

==== Did you know anything about currencies at the time? ====

I didn't even know what a Deutsche mark was. But, then again, no one in the department really knew much about currencies.

==== No one? ====

I Not really. There was one junior person on the desk who had previously worked for a bank.

==== Wasn't there anybody else in the firm with expertise in currencies? ====

No.

==== Why wasn't there any thought given to getting someone from the outside with experience to develop the department? ====

That's not how Salomon did things. At Salomon everything was home-grown. You're asking questions like you think there was some sort of written business plan. The reality was that a few senior people got together one day, and one said, "Hey, shouldn't we really start a foreign exchange department?"

"Okay. Who can we get to mn it?"

"How about Gil?"

"Okay. Hey, Gil. Do you want to run the department?"

"Sure, F 11 do it."

Gil came from bond arbitrage. He had no experience in currencies. His idea was to get a bunch of bright people together, figure out how this foreign exchange stuff worked, let them trade the product around, and see if they could make some money.

With no one in the department having any real background in currencies, how did you get the experience to know what to do?

One of the fellows in the department was very extroverted. He had us going out to dinner with international bankers three or four times a week. In those days, I was particularly shy. In fact, I remember one day one of the traders on the desk asked me to call Morgan Guaranty to place a D-mark transaction. I protested, saying, "But I don't know anyone there."

He said, "What do you mean you don't know anybody? Just pick up the Hambros [a book that lists all the international foreign exchange dealers], flip through, find Morgan's D-mark dealer, and call him."

I must have sat there agonizing for over ten minutes, trying to figure out how I could call somebody I didn't know.

==== Tell me about your early trading experiences m currencies. ====

At around the same time that the Salomon Brothers foreign exchange department was formed, the Philadelphia Stock Exchange introduced a currency option contract. I was the only one at the desk who even knew what a put or call was. Also, the product was being traded on a stock exchange with a specialist system, and I was the only one on the desk with any background in equities. Everyone else in the department came from fixed-incomeland, which is the forty-second floor. Equityland is on the forty-first, where I came from. I don't think anybody else in the department had ever even been on the forty-first. I also knew specialists and market makers on the Philadelphia Stock Exchange floor. No one else in the department even knew what a specialist was. [In a specialist system, a single individual matches buy and sell orders for a security, as opposed to an open outcry system, in which orders are executed by brokers shouting their bids and offers in a trading ring.] The situation was tailor-made for me. Gil said, "You're the only one in the department who knows anything about this, so just do it."

The key point I am trying to make is that Salomon's foreign exchange department, Bill Lipschutz as foreign exchange trader, and currency options all started at the same time, and we grew together. It was a unique, synergistic type of experience.

==== How did you become successful as a currency trader without any previous experience? ====

Foreign exchange is all about relationships. Your ability to find good liquidity, your ability to be plugged into the information flow-it all depends on relationships. If you call up a bank and say, "I need a price on ten dollar [$10 million] mark," they don't have to do anything. They can tell you, "The mark dealer is in the bathroom; call back later." If I call up at 5 P.M. and say, "Hey, Joe, it's Bill, and I need a price on the mark," the response is going to be entirely different: "I was just on my way out the door, but for you I'll see what I can do."

==== As someone brand new in the business, how did you develop these contacts? ====

One thing that helped me a great deal was that I had a background in options when it was new to the marketplace. "He knows options," they would say. Hell, I didn't know that much about it, but the point was that no one in foreign exchange knew very much about it either. Their perception was: "He can derive the

Black-Scholes model; he must be a genius." A lot of senior guys in the currency market wanted to meet me simply because their customers wanted to do options, and they needed to get up to speed on the subject quickly.

Also, I worked for Salomon Brothers, which at that time provided an element of mystique: "We don't know what they do, but they make a lot of money."

Another factor in my favor was that, although I worked for an

investment bank, I tried not to act like a pompous investment banker. The typical guys in investment banks who were doing foreign exchange back then were fixed-income types. They were prissy in the eyes of the FX [foreign exchange] guys. They wore suspenders and Hermes ties;

they were white-wine-and-arugula-salad type of guys. They were not the go-out-for-pasta-and-dribble-marinara-sauce-all-over-yourself type of guys, which is what the foreign exchange traders basically were. I was really different; my background was different.

I was the first person at Salomon Brothers to have a Telerate at home. They couldn't believe it. "You want a screen at home? Are you out of your mind? Don't you ever turn off?"

I would look at them and say, "Foreign exchange is a twenty-four-hour market. It doesn't go to sleep when you leave at 5 P.M. The market is really there all night, and it moves!"

==== Is having contacts important in order to be plugged into the news? ====

Absolutely. Those of us who did well were generally the ones who were accepted by the interbank circle. The traders who stayed aloof tended to be the ones who couldn't make any money trading foreign exchange. These traders would end up calling a clerk on the Mere floor [the Chicago Mercantile Exchange, which trades futures on currencies-an active but still far smaller market than the interbank market] and would say, "So, how does the Swissy look?" What is a clerk going to know about what is actually driving the international currency market? I would be talking to bankers throughout the day and night-in Tokyo, London, Frankfurt, and New York.

==== Were you trading off of this information flow? ====

That's what foreign exchange trading is all about.

==== Can you give me a recent example of how information flow helps in trading? ====

At the time the Berlin Wall came down, the general market sentiment was that everyone would want to get money into East Germany on the ground floor. The basic assumption was that large capital flows into Eastern Europe would most directly benefit the Deutsche mark. After a

while, the realization set in that it was going to take a lot longer to absorb East Germany into a unified Germany.

How does that shift in attitude come about? Kohl makes a statement; Baker makes a comment; statistics reveal very high East German unemployment. The East Germans, who have lived all their life under a socialist system, begin saying, "We don't want to work as hard as those West Germans, and by Hie way, how come the state is not paying for our medical bills anymore?" The investment community begins to realize that the rebuilding of Eastern Europe is going to be a long haul. As this thinking becomes more prevalent, people start moving capital out of the Deutsche mark.

==== You could have made all those same arguments when the wail first came down. ====

I don't think many people saw it that way at the time, and even if they did, that's not important. What is important is to assess what the market is focusing on at the given moment.

==== And the way you get that information is by talking to lots of participants in the foreign exchange market? ====

Yes. Not everyone is going to interpret things in the same way, at the same time, as you do, and it's important to understand that. You need to be plugged into the news and to know what the market is looking at. For example, one day the foreign exchange market may be focusing on interest rate differentials; the next day the market may be looking at the potential for capital appreciation, which is exactly the opposite. [A focus on interest rate differentials implies that investors will shift their money to the industrialized countries with the highest interest rate yields, whereas a focus on capital appreciation implies that investors will place their money in the countries with the strongest economic and political outlooks, which usually happen to be the countries with lower interest rates.]

==== Are there any trades that stand out from your early days as a currency trader? ====

In 1983, in the very early days of currency options trading on the Philadelphia Stock Exchange, one of the specialists was quoting a particular option at a price that was obviously off by 100 points. I bought fifty. Since this was a deep-in-the-money option, I immediately sold the underlying market and locked in a risk-free profit. [A deep-in-the-money option is just like an outright contract, with the added advantage that if the market has an extreme move the maximum risk is theoretically limited.]

I asked my broker whether the specialist was still offering to sell more options at the same price. "Yes," he replied, "the offer is still there."

"Buy another fifty," I said.

At the time, I was the only currency options trader on the Philadelphia Exchange that regularly traded in fifties. The entire daily volume in the market was only about two or three hundred contracts. I did another fifty, another fifty, and another fifty. Then Goldman Sachs came in and did fifty. All of a sudden, the specialist had sold three to four hundred of these options. He obviously thought he had a locked-in arbitrage profit, but he had done his arithmetic wrong. I knew exactly what was happening. Finally, I said to my broker, "Ask him if he wants to do one thousand."

"Just a second," he answered. The broker came back a half-minute later and said, "He'll do one thousand at this price."

The specialist had backed off his offer, but he was obviously still off by almost 100 points in his quote. Finally I said to my broker, "Tell him to call me on my outside line."

The specialist calls me up and says, "What are you doing?"

I respond, "What are you doing?"

He asks, "Do you really want to do one thousand?"

I answer, "Listen, you're off by a big figure on your price."

"What are you talking about?" he exclaims. I start walking him through the numbers. Before I finish he says, "I've got to go," and the phone goes dead.

I got off the phone and thought about it for a few minutes. I realized that holding him to the trade would put him out of business-a development that would be bad for the exchange and terrible for the product [currency options], which we were just beginning to trade in a significant way. I called my broker and said, "Break all the trades after the first fifty."

At about the same time, my outside phone line rang. The specialist

was on the other end of the line. "I can't believe it!" he exclaimed, agonizing over the immensity of his error. "This is going to put me out of business."

I said, "Don't worry about it, I'm breaking all the trades, except the first fifty."

(By the way, Goldman refused to break any of the 150 they had done. Years later, after the specialist company had gone out of business, and the individual specialist had become the head trader for the largest market maker on the floor, he always made it very difficult for Goldman on the floor.)

My action of breaking the trades represented a long-term business decision, which I didn't think about a lot at the time, but which I agonized over for years afterward.

==== Why is that? ====

I have a reputation as being one of the most-if not the most-hard-assed players in the market. I never, ever, ever, ever, cut anybody a break, because I figured that at Salomon everybody was trying to knock us off. I was sure that if the tables were reversed, no one would ever give us a break. My view was always that these are the rules of the game. I don't give any quarter, and I don't expect any quarter.

Traders would sometimes call up when they had just missed the expiration of an over-the-counter option that went out m the money. There were a million excuses: "I tried to get through earlier." "I forgot." "I'm only a few minutes late, couldn't you just make an exception?" I always knew that if we called late, no one would let us exercise. The fact is, in all the time I was there, we never missed an expiration. The argument I made was, "Look, we've put a lot of money and thought into our back-office operations. We've instituted numerous fail-safe measures to make sure that we don't make mistakes."

When I was working out the management company details with Merrill, they asked me how much they should budget for back-office errors. I said, "Zero."

They asked in disbelief, "What do you mean by zero?"

I said, "Zero. We don't have back-office errors."

They said, "What do you mean-of course you have back-office errors."

I answered, "No, we don't make errors. If you put in enough fail-safes, you don't make errors."

That was my attitude, and that was why I wouldn't break the rules. People who knew me really well would say, "Lipschutz, why do you have to be such a hard-ass about everything?" I would simply say, "Hey, these are the rules; that's the way the game is played." So for me, letting the specialist off the hook was very much out of character.

==== Did you decide to give the specialist a break because it was such an obvious mistake? Or because you thought it might threaten the longevity of what was then a fledgling exchange and product? ====

It was a long-term business decision based on the opinion that it would have been bad for my business to hold him to the trade.

==== Bad for your business in what way? ====

My business in trading currency options was exploding, and the Philadelphia Stock Exchange was where they were traded. (The over-the-counter currency options market was only just starting at the time.)

==== So you did it more to protect the exchange. ====

No, I did it to protect me.

==== To protect your marketplace? ====

That's exactly right.

==== Then, hypothetically, if the exchange had been there for ten years, trading volume was huge, and this trade would not have made any difference to the survival of the exchange, you would have made a different decision. ====

That's correct. It wasn't charity.

==== So the fact that it was such an obvious error... ====

No, that wasn't the motive, because I said to the broker, "Ask him to check his price." "Ask him if he is sure." "Ask him if he wants to do another fifty."

==== In the interbank market, don't the dealers sometimes inadvertently quote a currency off by one big figure-for example, the real price is 1.9140 and they quote 1.9240. Do you hold a dealer to the quote even if it's an obvious mistake? ====

The convention is that there has to be an honest attempt. Let's say that some news comes out and the market is moving like crazy. You may not even know what the big figure is. Assume a dealer quotes 1.9140, and you think the price should be 1.9240. The convention is to say, "1.9140. Are you sure? Please check your price." And if the dealer responds, "Yeah, yeah, yeah, I'm sure. Do you want to deal or don^t you?" then the price should stand.

==== Has this happened to you? ====

Yes, and I can tell you that every time that it has happened, the other institution has come back and either wanted to cancel the trade or split the difference.

==== And what did you say? ====

I refused, because I had asked them to verify the price.

There is a break in the formal interview to devour some Chinese food mat we have ordered in. During the meal, we continue to discuss markets. One of the subjects discussed is clearly stated to be off the record, because it contains a number of references regarding one of the exchanges. Since I believed that the comments and viewpoints expressed in this discussion would be of interest to many readers, I eventually prevailed on Lipschutz to permit the use of this conversation. In accordance with this agreement, I have edited out all specific references to the exchange, market, and traders.

==== In exchange-traded markets, do you believe that stops have a tendency to get picked off? ====

As you know, I do very little trading on exchanges with trading pits. The vast majority of my trades are done either in the interbank market or on the Philadelphia Exchange, which uses a specialist system. However, in answer to your question, I can teU you a story about a fellow who was at Salomon in the late 1980s. He had been trading a market that had gone into a narrow range, and trading activity had dried up. During this period, a lot of stops had built up right above this trading range. One day, this trader's clerk on the floor calls and says, "Listen, the talk is that tomorrow [a day on which the liquidity was expected to be substantially below normal because of a holiday affecting the cash market] they're going to gun for the stops above the market." At that point, the stops were relatively close-about 40 or 50 ticks higher.

The next day, this trader's plan is to sell the market heavily once the stops are hit, because he believes such a rally would be artificial and that the market would be vulnerable to a subsequent sell-off. During the morning, the market trades sideways and nothing happens. Then around 1 P.M., prices start to move-down.

==== You did say that the stops were above the market? ====

That's right. Anyway, the market moves down 50 points, 100 points, and within a few minutes the market is down over 200 points. What happened was that the floor traders went for the stops below the market, which were 200 points away, instead of the stops above the market, which were only 50 points away. The reason was that everybody was ready for the rally to take out the stops on the upside. Therefore, everyone was long, and the direction of greatest price vulnerability was on the downside.

During the sharp break, my friend realizes that the market is way overextended on the downside. He screams at his clerks, "Buy 'em! Buy any amount they'll sell you. Just buy 'em[1]" He was bidding for hundreds of contracts between 100 and 200 points lower, and he was only filled on fifty, even though the market traded down over 200 points, with a couple thousand lots trading at those levels.

==== What happened to his bid? ====

You've obviously never traded on the floor of an exchange. In a trading pit, it's possible for the market to trade at several different prices at the same moment during periods of rapid movement. They were looking right past my friend's floor brokers, who were bidding higher. It was a fast market. [When an exchange designates "fast market" conditions, floor brokers can't be held for failing to fill orders that were within the day's traded price range.] A fast market gives the floor brokers a special license to steal, above and beyond their normal license to steal.

I'm not making any allegations, because I can't prove that any of this happens. It's just my opinion that situations like this sometimes occur in some open outcry markets.

Dinner is over, and we return to the living room for a continuation of the interview "on the record."

==== Do you remember your first major trade and the thinking behind it? ====

The trade involved a bond issue that allowed for redemption in either sterling [another name for British pounds] or U.S. dollars. The issue was grossly underpriced-the problem was that it was mispriced by Salomon Brothers, one of the lead underwriters. When I first heard the details, I couldn't believe how mispriced it was. I actually wanted to buy the whole issue.

==== What was the essence of the mispricing? ====

At the time, U.K. interest rates were a lot lower than U.S. rates. Consequently, forward sterling was trading at a huge premium to the spot rate. [If two countries have different interest rates, forward months of the currency with lower rates will invariably trade at a premium to the spot currency rate. If such a premium did not exist, it would be possible to borrow funds in the country with lower rates, convert and invest the proceeds in the country with higher rates, and buy forward currency

positions in the currency with lower interest rates to hedge against the currency risk. The participation of interest rate arbitrageurs assures that the forward premiums for the currency with lower interest rates will be exactly large enough to offset the interest rate differential between the two countries.]

The way the bond issue was priced, the sterling redemption option essentially assumed no premium over the spot rate, despite the huge premium for the currency in the forward market. Therefore, you could buy the bond and sell the sterling forward at a huge premium, which over the life of the bond would converge to the spot rate.

==== What was the term of the bond? ====

The bond matured in four tranches: five, seven, nine, and twelve years.

==== I don't understand. Is it possible to hedge a currency that far forward? ====

Of course it is. Even if you can't do the hedge in the forward market, you can create the position through an interest rate swap. However, in the case of sterling/dollar, which has a very liquid term forward market, there was certainly a market for at least ten years out.

==== How big was the issue? ====

There were two tranches: the first for $100 million and the second for S50 million.

==== What happened when you pointed out that the issue was grossly mispriced? ====

The initial response was that I must be wrong somehow. They spent nine hours that day running it past every quant jock in the house until they were convinced I was right.

==== Did they let you buy the issue? ====

Yes, but by the time I got the approval, $50 million of the first tranche had already been sold. For the next year or two, I tried to acquire the rest of the issue in the secondary market. I always had a bid in for those bonds. Largely with the help of one salesperson who knew where the original issue was placed, over the next two years, I was able to acquire $135 million of the total outstanding issue of $150 million.

Once I bought the issue, I immediately sold an equivalent of 50 percent of the total amount in the forward sterling market. Remember that the forward pound was at a large premium. For example, the spot rate (and the rate at which the bonds were redeemable in sterling) was $1.3470, while seven-year forward sterling was trading at approximately $1.47 and twelve-year forward sterling at approximately $1.60. [The sale of half the total amount in the forward market effectively converted half the position into a proxy put on the British pound, while the original issue was, in effect, a call position. Thus, half the position was a call and half a put, the key point being that the put was established at a much higher price than the call. This gap essentially represented a locked-in profit, with the potential for an even greater profit if the forward pound moved below $1.3470 or above, say, $1.47 in the case of the seven-year tranche.]

Anyway, what ultimately happened is that U.K. interest rates eventually reversed from below to above U.S. rates, thereby causing the British pound forward rates to invert from a premium to a discount to the spot rate. I covered the whole position at a huge profit.

==== Are there any other trades in your career that stand out as particularly memorable? ====

One that comes to mind occurred at the time of the G-7 meeting in September 1985, which involved major structural changes that set the tone in the currency markets for the next five years. [This was the meeting at which the major industrialized nations agreed to a coordinated policy aimed at lowering the value of the dollar.]

==== You were obviously very closely tied into the currency markets. Did you have any idea that such a major policy change was at hand? ====

No. There were some people who had an inkling that there was going to be a meeting at which the Western governments were going to drive the dollar down, but nobody understood the magnitude of what that meant. Even after the results of the meeting were reported, the dollar traded down, but nothing compared to the decline that occurred in the ensuing months. In fact, after an initial sell-off in New Zealand

and Australia, the dollar actually rebounded modestly in Tokyo.

==== How do you explain that? ====

People didn't really understand what was happening. The general attitude was: "Oh, another central bank intervention." Remember that this meeting took place after years of ineffective central bank intervention.

==== What was different this time? ====

This was the first time that we saw a coordinated policy statement from the seven industrialized nations. Anyway, I was out of the country at the time of the G-7 meeting. I don't take vacations very often, but I had had a very good year, and I was in Sardinia at the time. Sardinia is fairly isolated, and it takes something like two hours to make an overseas call.

==== Were you aware of the situation? ====

I didn't even know what the G-7 was. The meeting didn't have any significant implication at the time; it was Just a bunch of bureaucrats getting together to talk down the value of the dollar.

==== There was never any G-7 meeting before that time that had any significant impact on the dollar? ====

Absolutely not. Anyway, I'm lying on the beach, totally oblivious to the ongoing bedlam in the world currency markets. For whatever reason- probably because it was close to the end of my vacation and I was starting to think about getting back into the markets-I decided to call my office early Monday morning. New York time, and check whether everything was running smoothly in my absence. With great difficulty, I finally got a line through to New York, but there was no answer in my office. The failure to get an answer was very unusual because my assistant, Andy [Andrew Krieger], always came in very early. I was a little concerned. I then called our London office to check on the currency markets.

"Dennis, what's going on in the currency market?" I asked.

"You know about the G-7 meeting, of course, don't you?" he asked.

"No," I answered. "What are you talking about?"

"Well, they've come up with this manifesto to bring down the value of the dollar, and the dollar is going to hell."

"Do you know where Andy is?" I asked.

"Oh, Andy is out sick today," he answered.

This was odd, because neither one of us was ever out sick. After a great deal of effort, I finally got through to Andy at home. He was in bed with the flu and running a high fever.

==== Did you have any position going into the G-7 meeting? ====

Yes, we had a small short dollar position, but nothing significant.

==== Did Andy have the authority to trade? ====

Yes, of course. He was not only monitoring my positions but was responsible for trading rather significant ones himself. The interesting thing was that as soon as Andy read the news, he went into the New Zealand market, which is the first of the world's currency markets to trade after the weekend. Not many people traded in that time zone, and it was a very thin market. I think he was only able to get price quotes at all because we (Salomon Brothers) frequently traded $20 million to $50 million on Monday mornings in New Zealand. Therefore, it was not abnormal for Andy or myself to call. We had established relationships in that trading center when very few others-New Yorkers or Europeans-had.

On very wide price quotes-literally two big figures wide because everyone was confused-he sold $60 million in New Zealand, which was a tremendous amount back then.

[At this point, Bill re-created Andy's conversation with the New Zealand Bank:]

"What's your price for twenty [million] dollars?"

"Two eighty bid, two eighty-two offered."

"Sold. How do you remain?"

"Two seventy-nine, two eighty-one."

"Yours twenty. How do you remain?"

"Two seventy-eight, two eighty."

"Yours twenty."

Andy was hitting bids six big figures below Friday's close. I was really impressed that he had that type of insight. I wouldn't have done that.

To make a long story short, for six hours I had an open line from my hotel room in Sardinia to Andy, who was out sick, flat on his back, in Englewood, New Jersey. It was so difficult getting an overseas phone connection that we just left the line open all day. Andy had the line to me and an open line to the floor on the Philadelphia Stock Exchange, where we were trading currency options. In addition, he had his wife run out to Radio Shack as soon as they opened to purchase one of those extra-long telephone cord extensions. He men brought in a third line from the neighbor's house to allow him to establish an open phone to our spot dollar/mark broker so that we could trade the cash market. We traded that way for six hours. We made $6 million that day, which at that time was probably more than 25 percent of our total annual profits.

We were staying at this luxurious resort that was largely frequented by wealthy Europeans. One humorous sidelight was that, while all that was going on, these two industrial magnate types-older German men, impeccably groomed, with perfect tans and accompanied by women who were obviously their daughters-kept coming by my room every ten minutes to ask in German what was happening. My wife did the translating. They knew that something important was going on in the foreign exchange market, but no one knew anything specific. Sardinia is so isolated that all the available newspapers are at least two days old. But I was

right there.

==== Were there any other trades that were particularly unusual for one reason or another? ====

One trade that was interesting because it turned into a virtual poker game occurred in 1987. I had put on a huge option spread position: long twenty-three thousand Japanese yen 54 calls and short twenty-three thousand 55 calls. If the calls expired in the money, each side of the spread would represent nearly $800 million-an enormous position at the time. When I put on the position, the calls were well out of the money.

[The position Lipschutz is describing is a bull call spread. In order for the trade to be profitable, the price of the yen must rise above 54 by an amount sufficient to at least offset the cost of the spread. Unlike a straight call position, however, the profit potential is limited to one full point per contract, since the long 54 call position is offset by the sale of an equal size 55 position. Although the sale of the 55 call limits the profit potential, it also substantially reduces the cost of the trade, as the income generated by selling the 55 call partially offsets the cost of buying the 54 call. The maximum profit would be realized at any price above 55, in which case each spread position would generate one full point profit ($625) minus the price difference between the 54 and 55 calls at the time of the position implementation. Given the numbers described by Lipschutz, the maximum profit potential on the entire spread, which again would occur at a price above 55, would approximate $13 million.]

The risk of doing this type of trade is that if the front strike is in the money but the back strike is not [i.e., a price between 54 and 55], you could end up exercising the long 54 call and not getting called away on your short 55 call. While this would imply a profit at expiration, it would also mean mat you would be left net long a near $800 million position, which would have to be carried over the weekend until the Tokyo market opened on Sunday night. In other words, you would be left with a tremendous risk exposure to an adverse price move over the weekend.

==== Couldn't you hedge the position near expiration? ====

You could if you were sure about whether the market was going to set-tie significantly above or below the 55 strike level. But what if the market is trading near the strike price as expiration approaches? In that case, you're not sure whether you're going to be assigned on the contracts or not. You certainly don't want to try to liquidate the entire twenty-three thousand contract spread position in the final hours of

trad-ing, since you would, have to pay away a tremendous amount in the bid/offer spread to get out of a trade that size at that point. If you don't hedge the long 54 call position because of the assumption that the market will expire above 55 [an event that would cause the short 55 call to get exercised], but instead the market closes below 55, you can end up carrying a net huge long position over me weekend. If, on the other hand, you hedge your long 54 call position on the assumption that the market is going to close below 55, but instead it closes above 55 and the short 55 call is exercised, then you can end up net short the entire face amount over the weekend. It's the uncertainty about whether the market will close above or below 55 (or, equivalently, whether or not your short 55 call position will be exercised) that makes it impossible to effectively hedge me position.

One particularly interesting element of the trade was that one market maker was on the opposite side of about twenty thousand lots of the spread position. When you deal with positions of That size on an exchange, you generally know who is on the other side.

The expiration day arrives, and as the market is in its final hours of trading, guess what? The price is right near 55. The market-making firm doesn't know whether I have hedged my long 54 call or not, and I don't know whether they have hedged their short 54 call or plan to exercise their long 55 call to offset the position. Neither one of us will know the other's position until Sunday morning, which is when you get notified of any option exercises.

On Sunday evening we get to play the same poker game alt over again in the Tokyo market. If they have exercised their long 55 call (making me short that position), they won't know if I'm short yen or not, depending on whether or not I've hedged. If they haven't exercised their call, they won't know if I'm net long yen or neutral, again depending on whether or not I'm hedged. For my part, I also won't know whether they are net long, short, or neutral, since I don't know whether or not they have hedged. Consequently, going into the early New Zealand and Australian market openings, either I'm going to be long nearly $800 million worth of yen and they are going to be short the same position, or they are going to be long that amount and I'm going to be short, or one of us is going to have a net long or short position while the other is hedged, or we could both. be hedged. Neither one of us will be able to figure out the other's position with any certainty, and

given our size at that time of the day in those trading centers, we're the only game in town.

On Friday afternoon (the expiration day), I heard that the firm on the other side of the trade was buying yen in the cash market. They had tipped their hand. I knew then that they had not already hedged their short 54 call position and had no intention of exercising their long 55 calls.

At 5 P.M., the yen closed within one tick of the 55 strike level. Because of the other firm's actions in the cash market, I thought they probably wouldn't exercise their long 55 calls, but I couldn't be certain.

On Saturday, the phone rang and it was the other firm's trader. "How are you doing?" I asked.

"Very good. How are you doing?" he asked in return. "I don't know, you tell me," I answered. Remember, you don't get your notices until Sunday, and this conversation was taking place on Saturday. "What did you do?" I asked.

He said, "What do you think I did? You'll never guess." "Well, I think you kind of tipped your hand on Friday afternoon," I answered.

"Yeah, that was the stupidest thing," he said. The purchase of yen in the interbank market hadn't been his decision; it was a committee decision at his company. He finally told me, "We're not going to exercise."

==== Did he just call to let you know that they weren't going to exercise and let you off the hook? ====

I would have had that information prior to the New Zealand opening anyway. He was probably trying to sniff out my position-that is, whether I had hedged or not. If he could figure out what I had done, there would be a potential play for him in the marketplace. As it turns out, I had not hedged, and I was net long the yen position. If he knew that, he could have gone into New Zealand, which is the first interbank market to open, and pushed the market against me. By telling him that they had tipped their hand by selling the yen on Friday afternoon, I let him believe that I had figured out their position-which I had-and hedged-which I had not. In any event, there was some news over the weekend, and the dollar opened up sharply lower against the yen. I actually ended up substantially increasing my profit on the trade.

==== How much did you end up making on that trade? ====

A totally ridiculous amount-something like $20 million. However, the thing that was so great about the trade was not the money but the mental chess game that Friday afternoon-all the back-and-forth bluffing. People were calling my desk all Friday afternoon to ask us what was going on between us and the other firm. There was nothing else going on in the market. These were the biggest positions in the market by a hundredfold that day.

Are there any other trades you can think of that were particularly memorable?

I can tell you about the one time since I first started trading that I was really scared. In fall 1988, there wasn't much going on in the currency markets. The D-mark had been in a very tight trading range. As was very typical in those types of low-volatility periods, our position size tended to grow as we tried to capture smaller and smaller price moves and still produce the same results. As a result, our position size at the time was larger than normal.

We knew that Gorbachev was going to make a speech at the UN, but we didn't know what he was going to say. At the time, I was short about $3 billion against the D-mark.

==== Three billion! Was that the largest position size you ever traded? ====

I've been bigger, but that was a very large position. The market had been trading in a narrow 1-2 percent range, and I had expected that sideways price action to continue. Then Gorbachev made a speech about troop reductions, which was interpreted by the market as meaning that the United States could also cut its armed force commitment- a development that would be beneficial for the budget deficit. All of this was considered very bullish for the dollar. The dollar started moving up in New York, and there was no liquidity. Very quickly, it was up 1 percent, and I knew that I was in trouble.

==== One percent of a $3 billion position is $30 million! Did this loss transpire in just one afternoon? ====

It transpired in just eight minutes. All I wanted to do was to make it through to the Tokyo opening at 7 P.M. for the liquidity. If you really have to buy $3 billion, you can do it in Tokyo; you can't do it in the afternoon market in New York-you can't even do it on a normal day, let alone on a day when major news is out. My strategy was to try to cap the dollar in New York. Normally, if you sell several hundred million dollars in the afternoon New York market, you can pretty much take the starch out of the market. I sold $300 million, and the market went right through it.

The people on my desk didn't really know the size of our position, with the exception of Robert, who was my number two man. I looked at Robert and said, "That didn't slow the market down too much, did it?" He grimaced and shook his head slowly from side to side. I realized that I couldn't cover these positions. I was really scared. I remember thinking: This is the bullet that finally catches me in the back of the head.

Tom Strauss, the president of the company, sat about fifteen feet away from me. (Gutfreund was not there that day.) I got up and walked over to Strauss and said, "Tommy, we have a problem." He looked at me and calmly said, "What is it?" I answered, "I'm short the dollar and I've misjudged my liquidity in the market, I've tried to hold the market down, but it's not going to work. And I can't buy them back."

He very calmly asked, "Where do we stand?" "We're down somewhere between seventy and ninety million." "What do we want to do about this?" he asked. I distinctly remember being struck by the fact that he used me word we, not you.

I said, "If I try to buy some back, I may get a little here and a little there, but it won't amount to very much, and we'll just end up pushing the market further against us. The first liquidity is Tokyo." "What's the plan?" he asked.

I answered, "When Tokyo opens, I have to see where it's trading. My intention now is to cover half the position at that time, and go from there.

He said, "We've had a good mn on this. Do what you need to do." That was the entire conversation. It was over in two minutes.

In discussing this episode several days later, Robert said, "I never saw you look like that." I asked him what he meant. He answered, "You were as white as a. sheet." My perception of what was going on around me at the time was, of course, quite distorted because I was so focused on that situation. I was later told that, for the entire afternoon, there was virtually not a word spoken on the desk and that Robert didn't let anybody come near me. I was oblivious to all this at the time.

Continuing our conversation, Robert said, "I don't know how you went over to Strau-ss."

"Why?" I asked. "What would you have done? It was me only thing I could do; I had to inform Strauss about what was going on."
Robert responded, "Ninety million. You were down $90 million! Do you understand what that means?" I asked, "What would you have done?"
He answered, "I would have put my coat on and walked out of here. I would have figured that was it, it's over, I'm fired."
Now, I don't Iknow if that's what he really would have done, but it never occurred to me to walk out. The idea that I had possibly just lost my job never entered my mind. This was a firm that bore me and nurtured me; it was just inconceivable that that could happen. The first thing I thought about was the position. The second thing I thought about was making sure that management knew about it. In absolute consistency with the firm's approach, as exemplified by Tom Strauss's response, there wasn't going to be any negativity in our conversation. It was a measured discussion, but if there was going to be any analysis of what went wrong, it would be after the situation was resolved.

==== What eventually happened to the position? ====

By the time Tokyo opened, the dollar was moving down, so I held off covering half the position as I had previously planned to do. The dollar kept on collapsing, and I covered the position in Europe. I ended up with an $18 million loss for the day, which at the time seemed like a major victory.

==== Most people in your situation would have been so relieved to get out that they would have dumped the position on the Tokyo opening. Apparently, you deferred to your market judgment and avoided that emotional temptation. ====

The reason that I didn't get out on the Tokyo opening was that it was the wrong trading decision. Actually, I'm a much better trader from a bad position than from a good position.

==== What did you learn from the entire experience? ====

Mostly I learned a lot about the firm and myself. I have a lot of respect for Salomon's willingness to understand what happens in the markets. If you want to play the game, sometimes somebody is going to get assassinated, sometimes someone is going to make a speech at the UN, and you're going to be on the wrong side of the trade-it's just the way it is. Exogenous events are exogenous events. They really understood that.

==== You said that you also learned about yourself. What did you learn? ====

That was the first time it hit home that, in regards to trading, I was really very different from most people around me. Although I was frightened at the time, it wasn't a fear of losing my job or concern about what other people would think of me. It was a fear that I had pushed the envelope too far-to a risk level that was unacceptable. There was never any question in my mind about what steps needed to be taken or how I should go about it. The decision process was not something that was cloudy or murky in my vision. My fear was related to my judgment being so incorrect-not in terms of market direction (you can get that wrong all the time), but in terms of drastically misjudging the liquidity. I had let myself get into a situation in which I had no control. That had never happened to me before.

==== Any other traumatic trading experiences? ====

You never asked me about what happened to my own account.

==== All right, what happened? As I remember, you started out with about $12,000. ====

That's right, and the peak was about $250,000.
Really? You had built it up that much!
Well, this was over a period of about four to five years.
Still ...
Yes, I had a lot of success. Anyway, I ended up blowing out virtually the entire account in a few days.

==== What happened? ====

On September 23, 1982, the Dow went from down 30 points to closing up 20. This was the famous Granville reversal, which was the bottom of the bear market.

==== Does "Granville reversal" refer to the rally occurring just after Joe Granville [an extraordinarily popular market advisor at the time] had put out a sell recommendation? ====

Exactly. I was very bearish and heavily long puts. I kept pyramiding all the way down. I was really pressing. I lost most of the money that Monday, and by Wednesday the account was virtually all gone.

==== You took over four years to turn $12,000 into $250,000 and lost it all in a matter of days. Did you have a moment of self-questioning? ====

No, I just saw it as one major mistake. I've always had a lot of confidence as a trader. My feeling was that I had developed and practiced the basic trading skills that had landed me at Salomon Brothers and that I had a tremendous amount of fun in the process. I was devastated by the way I had traded, but the money never had a major effect on me.

==== Did you change anything because of this experience? ====

I decided that since I was going to work for Salomon Brothers, all my attention should go into doing that very well, not trading my own account. After that point, I never again traded my own account-not because I had lost money but because I didn't want to split my focus, as I saw some other people do over the years. I basically took my pay-check every two weeks and put it in a money market account-a government-securities-only money market account because I wanted the extra protection.

==== How did the sudden demise of your personal account change you as a trader? ====

I probably became more risk-control oriented. I was never particularly risk averse.
==== What do you mean by "risk control"? ====
There are a lot of elements to risk control: Always know exactly where you stand. Don't concentrate too much of your money on one big trade or group of highly correlated trades. Always understand the risk/reward of the trade as it now stands, not as it existed when you put the position on. Some people say, "I was only playing with the market's money." That's the most ridiculous thing I ever heard. I'm not saying that all these concepts crystallized in one day, but I think that experience with my own account set me off on the track of considering these aspects much more seriously.
==== On the subject of risk control, how do you handle a losing streak? ====
When you're in a losing streak, your ability to properly assimilate and analyze information starts to become distorted because of the impairment of the confidence factor, which is a by-product of a losing streak. You have to work very hard to restore that confidence, and cutting back trading size helps achieve that goal.
==== With all the loyalty you had to Salomon, why did you eventually leave? ====
Gil, who started the department, left in 1988, and I ended up running the department for a year and a half. I would find myself talking on the phone a lot-not about trading, but rather about a lot of personnel problems. I was also not crazy about traveling all over. I didn't like managing people in Tokyo, London, and New York.
I wanted to bring someone in as a comanager for the department. I wanted to run trading and let someone else run the administrative side. That's not the style of Salomon Brothers, however. Instead they brought in someone from above me. Initially, I thought that it might work out, but the person they picked had no foreign exchange background at all. He came from the fixed-income department and saw everything in the eyes of the bond world. He would frequently ask, "Gee, isn't that just like the government bond market?" The answer in my mind was, "No, it's nothing like the government bond market. Forget the government bond market."
==== How does your current trading for your own management firm differ from your trading at Salomon? ====
At the moment, I'm trading a lot smaller than at Salomon, which is a disadvantage.
==== How is large size an advantage? You're kidding. ====
No, I'm serious.
If a big buyer comes in and pushes the market 4 percent, that's an advantage.
He still has to get out of that position. Unless he's right about the market, it doesn't seem like large size would be an advantage.
He doesn't have to get out of the position all at once. Foreign exchange is a very psychological market. You're assuming that the market is going to move back to equilibrium very quickly-more quickly than he can cover his position. That's not necessarily the case. If you move the market 4 percent, for example, you're probably going to change the market psychology for the next few days.
==== So youre saying size is an advantage? ====
It's a huge advantage in foreign exchange.
==== How large an account were you trading at Salomon? ====
That question really has no direct meaning. For a company like Salomon, there are no assets directly underlying the trading activity. Rather, over time, the traders and treasurer built up greater and greater amounts of credit facilities at the banks. The banks were eager to extend these credit lines because we were Salomon Brothers. This is an example of another way in which size was an advantage. By 1990, our department probably had $80 billion in credit lines. However, no specific assets were segregated or pledged to the foreign exchange activities.
==== I would like to get some feeling for how you reach your price directional decisions. Strictly for purposes of illustration, let's use the current outlook for the Deutsche mark. I know that you expect the dollar to gain on the Deutsche mark. What is your reasoning behind the trade? ====
First of all, I'm very concerned about the effects of unification on the German economy. There are tremendous infrastructure problems in East Germany that may take a decade or longer to solve. Also, the plans to restructure the Bundesbank [me German central bank] to include representatives of the former East German central bank create a lot of uncertainty. Finally, Kohl's government currently appears to be on a much weaker footing. All of these factors should operate to provide disincentives for capital flowing into Germany.
At the same time, a combination of low U.S. interest rates, an apparent desire by the Federal Reserve to continue to stimulate the economy, and preliminary signs of favorable economic data suggest that the United States may be coming out of its recession. Therefore, people are starting to think that the United States may not be a bad place in which to invest their money.
==== Having established a long-term philosophy about which way the currency is going-in this case, the dollar going higher against the D-mark-how would you then recognize if that analysis were wrong? ====
Events that would change my mind would include evidence that the German government was dealing effectively with some of the problems I listed before and economic statistics suggesting that my assumption of an end to the U.S. recession was premature-essentially, the converse of the situation I described for making me bullish on the dollar.

==== For argument's sake, let's say that the fundamentals ostensibly don't change but the dollar starts going down. How would you decide that you're wrong? What would prevent you from taking an open-ended loss? ====

I believe in this scenario very strongly-but if the price action fails to confirm my expectations, will I be hugely long? No, I'm going to be flat and buying a little bit on the dips. You have to trade at a size such that if you're not exactly right in your timing, you won't be blown out of your position. My approach is to build to a larger size as the market is going my way. I don't put on a trade by saying, "My God, this is the level; the market is taking off right from here." I am definitely a scale-in type of trader.

I do the same thing getting out of positions. I don't say, "Fine, I've made enough money. This is it. I'm out." Instead, I start to lighten up as I see the fundamentals or price action changing."

==== Do you believe your scaling type of approach in entering and exiting positions is an essential element in your overall trading success? ====

I think it has enabled me to stay with long-term winners much longer than I've seen most traders stay with their positions. I don't have a problem letting my profits run, which many traders do. You have to be able to let your profits run. I don't think you can consistently be a winning trader if you're banking on being right more than 50 percent of the time. You have to figure out how to make money being right only 20 to 30 percent of the time.

==== Let me ask you the converse of the question I asked you before: Let's say that the dollar started to go up-that is, in favor of the direction of your trade-but the fundamentals that provided your original premise for the trade had changed. Do you still hold the position because the market is moving in your favor, or do you get out because your fundamental analysis has changed? ====

I would definitely get out. If my perception that the fundamentals have changed is not the market's perception, then there's something going on that I don't understand. You don't want to hold a position when you don't understand what's going on. That doesn't make any sense.

==== I've always been puzzled by the multitude of banks in the United States and worldwide that have large rooms filled with traders. How can all these trading operations make money? Trading is just not that easy. I've been involved in the markets for nearly twenty years and know that the vast majority of traders lose money. How are the banks able to find all these young trainees who make money as traders? ====

Actually, some of the large banks have as many as seventy trading rooms worldwide. First of all, not all banks are profitable in their trading every year.

==== Still, I assume that the majority are profitable for most years. Is this profitability due to the advantage of earning the bid/ask spread on customer transactions, or is it primarily due to successful directional trading? ====

There have been a lot of studies done on that question. A couple of years ago, I read a study on the trading operations of Citibank, which is the largest and probably the most profitable cuirency trading bank in the world. They usually make about $300 million to $400 million a year in their trading operations. There is always some debate as to how they make that kind of money. Some people argue that Citibank has such a franchise in currency trading that many of the marginal traders and hedgers in the currency market immediately think of Citibank when they need to do a transaction-and Citibank can earn a wide spread on those unsophisticated trades. Also, Citibank has operations in many countries that don't have their own central bank. In these countries, much or even all of the foreign currency transactions go through Citibank. The study concluded that if Citibank traded only for the bid/ask spread and never took any position trades, they probably would make $600 million a year.

==== That would imply that they probably lose a couple of hundred million dollars a year on their actual directional trading. Of course, that would help explain the apparent paradox posed by my question-that is, how can all those traders make money? Am I interpreting you correctly? ====

Personally, that's what I believe. However, the argument within Citibank would probably be; "We doubt that's true, but even if it were, if we weren't in the market doing all that proprietary trading and developing information, we wouldn't be able to service our customers in the same way."

==== That sounds like rationalization. ====

Assume you're a trader for a bank and you're expected to make $2.5 million a year in revenues. If you break that down into approximately 250 trading days, that means you have to make an average of $10,000 a day. Let's say an unsophisticated customer who trades once a year and doesn't have a screen comes in to do a hedge. You do the trade at a wide spread, and right off the bat you're up $110,000. You know what you do? You spec your buns off for the rest of the day. That's what almost every currency trader in New York does, and it's virtually impossible to change that mentality. Because if you are lucky, you'll make $300,000 that day, and you'll be a fucking hero at the bar that night. And if you give it all back-"Ah, the market screwed me today."

==== Bottom line: If it weren't for the bid/ask spread, would the banks make money on their trading operations? ====

Probably not in conventional position trading in the way you think of it. However, there is another aspect of directional trading that's very profitable. Take Joe Trader. Day in. day out, he quotes bid/ask spreads and makes a small average profit per transaction. One day a customer comes in and has to sell $2 billion. The trader sells $2.1 billion, and the market breaks 1 percent. He's just made $1 million on that one trade.

==== In a lot of markets that's illegal. It's called frontrunning. ====

It's not illegal in the interbank market. He's not putting his order in front of the customer's; he's basically riding his coattails.

==== So he does the whole order at the same price? ====

Generally, the first $100 million would be the bank's. That's just the way the market is.

==== Is there any difference between that transaction and what is normally referred to as frontrunning? ====

Yes, it's legal m one market and illegal in the other.

==== That's the answer from a regulatory viewpoint. I'm asking the question from a mechanical perspective: Is there an actual difference in the transaction? ====

The real answer is no, but I'll give you the answer from a bank's perspective. When I allow you to come in and sell $2 billion in the foreign exchange market, I'm accepting the credit risk and providing the liquidity and facility to make that trade. In exchange, you're providing me with the information that you're about to sell $2 billion. That is not a totally unreasonable rationalization.

==== How do you move a large order like $2 billion? How do you even get a bid/ask quote for that amount? ====

I'll tell you what happens. Let's say an order comes in for $500 million or more. The dealer stands up and shouts, "I need calls!" Immediately, among the dealers, junior dealers, clerks, and even the telex operators, you have forty people making calls. Everyone has their own call lists so they don't call the same banks. They probably make an average of about three rounds of calls; so there are 120 calls in all. All of this is done in the space of a few minutes. The dealer acts as a coordinator- the bank staff shouts out bids to him and he calls back, "Yours! Yours! Yours!" all the time, keeping track of the total amount sold. A large bank can move an amazing amount of money in a few minutes.

==== When you get right down to it, virtually all the trading profits seem to come from profit margins on the hid/ask spread and coattailing of large orders. That makes a lot more sense to me, because I couldn't figure out how the banks could hire all those kids right out of school who could make money as traders. I don't think trading is that easily learned. ====

You know my pet peeve? Is *that* trading? Even at Salomon Brothers, where there's a perception that everyone is a trader, it came down to only about a half-dozen people who took real risk. The rest were essentially just making markets. That nuance is lost on most people.

==== Getting hack to the credit risk associated with the interbank market that you mentioned earlier, when you do a trade, are you completely dependent on the creditworthiness of the other party? If they go down, are you out the money? ====

You got it.

==== Has that ever happened to you? ====

No.

==== How often does it happen? ====

If a trade involves anyone who is even in question, you can ask them to put up margin.

==== Isn't it possible for a bank with a good credit rating to suddenly go under? ====

Suddenly? No. What is the worst case you can think of? Drexel? Salomon stopped doing currency transactions with Drexel a year and a half before they went under.

==== Are you saying that there's not much of a credit risk involved? ====

There is some risk, but does a Conti fail overnight? We stopped trading with Conti five months before the Fed bailed them out.

==== But someone was trading with Conti in those last few months. Were they just less well informed? ====

Not necessarily. They were just willing to take the risk. You can be sure that in those final months, Conti was not dealing at the market. At a certain interest rate level, you would lend any bank money. The reason why surprises don't happen is because it's in everyone's interest to know when there is a problem. Therefore, credit officers are very quick to share information whenever they think a problem exists.

==== Do you ever have dreams about trades? ====

On one particular occasion, I had a very specific dream the night before a balance-of-trade number was to be released. I dreamt that the trade figure would be a specific number; the revision would be a specific number; the dollar would move up to a certain level, and I would buy dollars; the dollar would move up to a second level, and I would buy more dollars; the dollar would move up to a third level, and I would buy yet again; the dollar would move up to a fourth level, and I would want to sell but would buy again.

The next day, the trade number came out, and it was exactly the same number as in my dream. The revision was also exactly the same number. Even the price sequence was exactly the same as in my dream. The only difference was that [he pauses] I didn't trade at all.

==== I Why not? ====

Because I don't trade on dreams or rumors. I'm a fundamental trader. I try to assemble facts and decide what kind of scenario I think will unfold. To walk in and trade on a dream is absurd. I told my assistant about my dream, and we laughed about it. He said, 'The day you start trading on dreams is the day we might as well pack it up."

As I watched the price action unfold, the market looked good at each of the price levels. Ironically, if I had

never had (he dream, I might very well have bought dollars.

==== In your conscious state, you agreed with the basic trade. Right? ====

Absolutely.

==== Was it a matter of not taking the trade because you didn't want to appear to be trading on a dream? ====

Very much so. Within myself, I was very confused as to what was happening. It was a very odd experience.

==== Was it sort of shades of the Twilight Zone? ====

Just like it. I couldn't believe it. My assistant and I just kept looking at each other. When the trade numbers came out exactly as I had dreamt, he said, "Billy, come on, where did you get those numbers?"

==== Has this type of experience happened to you at any other time? ====

That was the rime that I remember the best. I had similar experiences on other occasions, but I don't remember the specifics as clearly.

==== **Do you want my theory on a logical explanation?** I'd love to hear it. How do you explain picking the exact number? ====

You work, relax, eat, and literally sleep with the markets* You have a storehouse of fundamental and technical information embedded in your mind. Let's say that because of some unconscious clues you picked up-maybe something somebody said, or some positions you saw certain people take, or whatever-you thought that the trade numbers would be out of line with expectations. But for some reason, you didn't want to trade on this expectation. Maybe, in this case, the expectation seemed irrational and you would have felt stupid trading on it. Maybe you don't like trading in front of the release of government numbers because of some past negative experiences. The reason is not important. I'm just making up examples* The point is that it's easy to envision how you might correctly anticipate an unreleased statistic and why such a projection might occur on a subconscious level*.

Your projection of the market moving in a certain direction is even easier to explain. Given your vast experience, once you were right about the trade numbers, it would hardly be surprising that you would get the direction of the market right. Even dreaming about the exact price levels is not so absurd, because you have an exceptional feel for market swings. In fact, just the other day, I saw you pause in midconversation to place a buy order in a plummeling Australian dollar market at what proved to be the exact turning point.

All I'm saying is that all this information is in your mind, and it may come out in a dream because, for whatever reason, you haven't translated it into action. There is nothing particularly mysterious about it. You don't have to believe in p recognition to explain it.

You can even argue further that playing out scenarios is something that I do all the time. That is a process a fundamental trader goes through constantly. What if this happens? What if this doesn't happen? How will the market respond? What levels will the market move to?

==== So you think that not backing up an expected scenario by taking a position will tend to force it out in the subconscious mind as a dream? ====

Sometimes-sure. I'm not speaking as an expert. I'm not a psychologist, but it seems logical to me. I'll give you a personal example. Several years ago, I had a strong feeling that the Canadian dollar was in the early stages of a multiyear bull market. The market had a good upmove and then went into a narrow consolidation. I felt it was going to go higher, but I was already long four contracts, which was a relatively large position for a single market, given my account size.

That night I had a dream that the Canadian dollar just went straight up. The next morning I came in and, right off the hat, I doubled my position from four to eight contracts. The market went straight up. I believe the reason this projection came out in a dream was that my logical mind couldn't accept taking the trading action dictated by my market experience. My logical side said, "How can I double my position when the market has gone straight up without even a slight reaction?" Of course, as we both know, trades that are the most difficult to take are often the successful ones.

==== On a somewhat related topic, do you believe that exceptional traders are aided by accurate gut feelings about the markets? ====

Generally speaking, I don't think good traders make gut or snap decisions-certainly not traders who last very long. For myself, any trade idea must be well thought out and grounded in reason before I take the position. There are a host of reasons that preclude a trader from making a trade on a gut decision. For example, before I put on a trade, I always ask myself, "If this trade goes wrong, how do I get out?" That type of question becomes much more germane when you're trading large position sizes. Another important consideration is the evaluation of the best way to express a trade idea. Since I usually tend not to put on a straight long or short position, I have to give a lot of thought as to what particular option combination will provide the most attractive return/risk profile, given my market expectations. All of these considerations, by definition, preclude gut decisions. Having said this, there are instances when, despite all my planning, trading decisions are made that might best be described as instinctive.

For example, consider the situation when I attempted to buy the Australian dollar the last time you were here. In that particular instance, the Australian finance minister had made a statement to the effect that he didn't care if the currency lost 10 percent of its value overnight. How do you react? Those types of panic situations are the instances when gut feeling comes into play. During the market turmoil that followed his

statement, I felt that there was no way the currency could adjust even remotely close to 10 percent before large buyers would come in and push it the other way.

==== How far was it down at the tune you entered your buy order? ====

About 5 percent. Even though I was already long a long-term position that was adversely affected by the news, I just felt that, over the short term, the market was bound to rebound.

==== How do you gauge when a panic has run its course? ====

I think it's a combination of market experience and innate feel. Many currency traders operate under rules that if they lose a certain amount of money, they must liquidate the position. Those are not the type of decisions that are made rationally given the specific situation at a given moment; rather, they are general rules that have been established previously. How do you decide when that type of last-ditch selling is nearly exhausted? It's probably largely a matter of past experience that has suffused your subconscious. In this sense, what people describe as gut feel is probably better described as subconscious market experience.

==== What do you believe are the characteristics of the truly superior traders? ====

Let me start with an analogy. When I was in college, my impression was that people who were really smart could do very well, even if they didn't work that hard, and people who really worked hard could also do very well, even if they weren't outstandingly bright. In contrast, in trading, I think you need both elements. The best traders I know are really quite brilliant, and they all work very hard-much harder than anyone else.

By the way, when I talk about working hard, I mean commitment and focus; it has nothing to do with how many hours you spend in the office. These traders have tremendous commitment to the markets-to their craft, so to speak. They develop scenarios, reevaluate scenarios, collect information, and reevaluate that information. They constantly ask themselves: What am I doing right? What am I doing wrong? How can I do what I am doing better? How can I get more information? It's obsessive.

==== Is this type of analysis something that's ongoing during all your waking hours? ====

Absolutely. Some professional traders may claim that they separate their personal life from their business life and are able to completely turn off on the weekends. I don't believe that for a second. I think that when they're relaxing in their sailboats, at some level they're still focused on the market.

==== I know you like to play golf. When you're out on the course, are you still thinking about the markets? ====

Probably so. The really best traders around don't think twice about how many hours they're working or whether they come in on a weekend. There's no substitute for that level of commitment.

==== When you're interviewing someone for a job as a trader, how do you determine whether they have that type of commitment? ====

Sometimes it's obvious. For example, in an interview someone might ask you, "What time do I have to come to work in the morning?" In my opinion that's a very bizarre question. Come in whatever time you believe is appropriate. "How late do I have to stay in the afternoon?" Leave whenever you want. I'm not going to tell someone when to come in and when to leave.

==== Besides intelligence and extreme commitment, are there any other qualities that you believe are important to excel as a trader? ====

Courage. It's not enough to simply have the insight to see something apart from the rest of the crowd, you also need to have the courage to act on it and to stay with it. It's very difficult to be different from the rest of the crowd the majority of the time, which by definition is what you're doing if you're a successful trader.

Many people think that trading can be reduced to a few rules. Always do this or always do that. To me, trading isn't about always at all; it is about each situation.

So many people want the positive rewards of being a successful trader without being willing to go through the commitment and pain. And there's a lot of pain.

==== The pain being what? ====

You give up a lot of things. It's all tradeoffs. It's the middle of the night, everyone else is asleep, and you're sitting in front of a machine with glowing green numbers, with a pain in your psyche because the market is going against you and you don't know whether the fundamentals have changed or whether it's just a meaningless short-term move. Those are very trying times.

==== Trading is such a pervasive element in your life, including being up half the night on a regular basis. Does this obsession, as you yourself termed it a little earlier, create a source of friction in your married life? ====

Not at all. My wife was a bond salesman at Goldman Sachs for many years. Personally, I think she would make a very good trader-she has many of the right qualities-but she doesn't want to trade. I wouldn't lessen it by saying simply that she is understanding, because that sounds so docile. She's more than understanding; she's fully cognizant, supportive, and I think she gets a big thrill out of what I do.

==== Why do you trade? ====

I like the game. I think it's a great challenge- It's also an easy game to keep score of.

==== With trading consuming most of your day, not to mention night, is it still fun? ====

It's tremendous fun! It's fascinating as hell because it's different every day.

==== Would you still trade if there were no monetary remuneration? ====

Absolutely. Without question, I would do this for free. I'm thirty-six years old, and I almost feel like I have

never worked. I sometimes can't believe I'm making all this money to essentially play an elaborate game. On the other hand, when you look at all the money I've produced over the years, I've been vastly underpaid.

The more supertraders I interview, the more convinced I become that, at least to some degree, their success can be attributed to an innate talent. Bill Lipschutz provides an excellent example. His first encounter with trading actually involved paper trading in a college investment course. Lipschutz ended up running a hypothetical $100,000 into an incredible $29 million by the end of the course. Although this accomplishment has to be taken with a grain of salt because it didn't involve real money and the rules of the experiment were flawed by the lack of realistic limitations on leverage, the results were striking nonetheless.

Lipschutz's first experience in actual trading was prompted by a $12,000 inheritance that he steadily built up to $250,000 over a four-year period. Although he ended up blowing the entire account because of one drastic mistake of wildly overleveraging his position, that does not take away from the skill that was needed to produce the steady equity growth in the first place.

Finally, and most important, despite having had no previous experience whatsoever in the currency markets, Lipschutz was significantly profitable in his very first year of trading these markets and extraordinarily profitable over the next seven years. Although he declines to quote any specific figures, it has been estimated that his trading alone accounted for an excess of one-half billion dollars in profits for Salomon Brothers over his eight-year stay with the firm.

Lipschutz himself cites hard work and an all-consuming commitment to the markets as the principal ingredients for his success, Although hard work by itself is not sufficient to make one a great trader, it does appear to be an important ingredient in the success of many of the world's best traders. Lipschutz also believes that superior intelligence is an important ingredient to trading success. However, it should be noted that others whom I have interviewed (e.g., Victor Sperandeo) do not share this view.

One theme that seems to recur in many of my conversations with the world's top traders is their view of the markets as a wonderful game rather than as work. Lipschutz emphatically claims that, for him, trading is such an engaging game that he would do it for free if he had to.

One lesson that could be drawn from Lipschutz's trading style is that you don't have to get in or out of a position all at once. Lipschutz scales in and out of virtually all his trades. One sensible piece of advice for most traders is this: Avoid the temptation of wanting to be completely right. For example, let's say you become convinced that a market should be bought, but prices have already had a sizable run-up. In many instances, if the trade is really good, by waiting for a significant reaction before putting on the entire position you are apt to miss the move completely. However, by adopting a scale-in plan-putting on part of the intended total position at the market and the remainder on a scale-down basis-you assure that you will at least have a partial position if the market keeps on going, without the excessive risk that would be implied by putting on the entire position after a large, uninterrupted advance.

As another example, assume that you are long with a large profit and are concerned about a market top. If you get out of the entire position and the market advance continues, you can miss a large part of the total move. On the other hand, if you keep the entire position and the market does indeed top, you can end up giving back a very large portion of the gain. By using a scale-out approach, you may never get the best outcome, but at the same time you will never get the worst outcome either. Also, by using a scale-in and scale-out approach, you can restrict full positions to those instances in which your confidence in a trade is greatest.

Another lesson to be learned from this interview is that if you have a strong conviction about a trade and the market has a large move because of a news event, the best decision may well be to bite the bullet and buy on extreme strength (or sell on extreme weakness). A perfect example of this concept was provided by the way the trader in Lipschutz's group handled trading the market following the G-7 meeting.

In Market Wizards, Marty Schwartz made the observation that if a trade that you are very worried about does not turn out as badly as feared, don't get out. The rationale is that if there is no follow-through in a direction adverse to your position, then there must be some very strong underlying forces in favor of the direction of the original position (since the reasoos-fundamental or technical-for your own fears are probably shared by many others in the marketplace). A prime example of this rule in action was provided by the one trade that Bill Lipschutz admitted scared him. In that instance, he was short a very lage dollar position against the D-mark in the midst of a shan, dote rally and had to wait for the Tokyo opening to find sufficient liquid, y to ex, the position. However, by the time Tokyo opened, the dollar wa weaker, letting him off the hook easily and therefore implying that he shouldn't get out. Lipschutz, being a highly skilled trader, responded exactly right and delayed liquidating his position, thereby recoupingmost of his loss.

One item I found particularly curious was that. atter more than four years of steady trading gains in his stock option account. Lipschutz lost virtually the entire amount in a few days- nme. Ironically, this loss coincided with his start of fall employment at Salomon Brothers. Interestingly. as expressed in the interview, he had strong feelings agiuns simultaneously trading personal and company accounts. The demise of his own account, therefore, played neatly into avoiding .my potent source of conflict. In our conversation, Lipschutz insisted that the loss was probably coincidental since he was only in the training class and not yet aware of any potential conflict.

Despite Lipschutz-s denial. I couldn't help but be reminded of the provocative aphorism: "Everybody gets what they want out of the market •." I wondered whether Lipschutz-s subconscious was perhaps a bit more foresightful than he realized. In any case, the timing of this large loss and its relative uniqueness in Lipschutz-s trading career does seem somewhat ironic. Whether this interpretation is strained comec ure or