Playing the Player

Yesterday we spoke of how my ignorance cost me a hell of a lotta emotional pain *plus* the huge sum of $127,562.06.

Realizing that I *wasn't* Trading Jesus and instead just another shitty, luck-dependent, losing trader was devastating…

But out of those ashes I discovered something that changed my game forever.

That *something* was **playing the player**…

Most of the knowledge I had previously learned from reading the market classics was superficial. I could *sound* really smart talking about markets, but from my results it was obvious I didn't know what I was doing. In reality I had been trading from a base of fear and ignorance because I never learned how to properly to play the game.

Playing the player is what finally keyed me into the right way to approach markets. Instead of being a market sheep struggling to identify "value" or the next hot trend, I turned into a wolf exploiting those herds.

I finally became confident I was playing the *right* game. It felt natural to think of the market in terms of psychology. It fit with the way I was trained throughout my military years.

This is not to say trading suddenly became easy. It's still the toughest game in the world. But this new market vantage point helped me break free from the emotional tribulations I used to face. Now when I took a loss, I could handle it both emotionally and financially, because it was all apart of my process, and not solely dependent on luck and random market forces. I gained control over my results. Playing the player gave me the ability to confidently target solid returns year after year that were completely uncorrelated with the broader market.

My new approach also did another extremely important thing: it restored my *love* for the game. We all know how tough it is to keep going after getting beaten down again and again. It was pretty difficult for me to return to trading after stumbling out of the idiot tree and hitting every dimwit branch on the way down. The passion was still there, deep down, but the experience did a good job of pissing on the flames. *Playing the player* helped me break that negative pattern and get back to why I loved trading so much in the first place.

I'm gonna help you do the same. Today I want to go over exactly how YOU can use *play the player* to transform your trading like I did.

Why do I wanna help?

No… it's not because I'm the financial Santa Claus spreading market knowledge and cheer….

It's because our goal at Macro Ops is to continue strengthening our globally distributed intelligence network. The larger it grows and the more high-quality members it develops, the more lucrative asymmetric opportunities we find together. Basically I'm trying to teach you what I know so you'll be able to better contribute to our network. It's a win-win.

Now let's get started.

Playing the player all about exploiting the dominant/consensus belief…

The first thing you need to understand is that market prices aren't set according to independent facts. They're the result of an aggregation of various individuals' beliefs. The average of these beliefs sets the market price.

So really our goal isn't to identify "correct" asset pricing. There's no such thing. **We're just trying to figure out how and why *other* market participants are pricing assets the way they are.**

It goes back to the Beauty Contest analogy. John Maynard Keynes likened profitable investing to a common newspaper game of the time:

> *… in which the competitors have to pick out the six prettiest faces from 100 photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole: so that each competitor has to pick, not those faces that he himself finds prettiest, but those the he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view… We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth, and higher degrees.*

To understand how assets are being priced, we need to identify the beliefs driving the market. Now we can't possibly do this for *every* belief affecting pricing, but we don't need to. **We just need to identify the dominant beliefs.**

There's always one or two dominant beliefs driving prices because investors find safety in numbers. Most, whether they realize it or not, don't like to think for themselves. To quote Michael Lewis' *Liar's Poker*:

> *Investors do not fear losing money as much as they fear solitude, by which I mean taking risks that others avoid...They are, strangely enough, happy to stand on the edge of a precipice as long as they are joined by a few thousand others.*

Man's tendency towards herding ensures that large sections of the market will always interpret information through similar belief structures.

To *play the player*, all we have to do is sniff out these consensus views and exploit them.

For a further explanation of this concept, let's turn to Steven Drobny's interview with *The Philosopher* from his book *The Invisible Hands* (emphasis mine).

> *It is important to note that a key element to this exercise is the fact that what other people believe will happen is just as important as the eventual outcome.* ***A market is not a truth mechanism, but rather an interaction of human beings whereby their expectations, beliefs, hopes, and fears shape overall market prices.*** *People in the private equity business can decide if something is a good idea or not if held to maturity. My horizon is much shorter term.*
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> *A good example of this psychological element can be seen in inflation.* ***At the end of 2008, U.S. government fixed income was pricing in deflation forever. At that point, the only thing of interest to me was the question of whether people might think that there could be inflation at some point in the future.*** *Quantitative easing made it easy to answer this question affirmatively, because there are many monetarists in the world who believe that quantity of money is the driver of inflation.* ***Whether they are right or not is a problem for the future — what is important to me is that such people exist today.*** *Their existence makes the market pricing for U.S. long bonds completely lopsided. Such pricing only makes sense if you are a died-in-the-wool output gapper who believes that when unemployment goes up, inflation goes down, end of story.* ***Market prices reflect the probability of potential future outcomes at that moment, not the outcomes themselves.*** *Some people do not believe in the output gap theory of inflation, and these people believe that pricing for U.S. bonds should be somewhere else. Because these two divergent schools of thought exist, it is possible that market sentiment can shift from deflation to inflation and that pricing will follow.*
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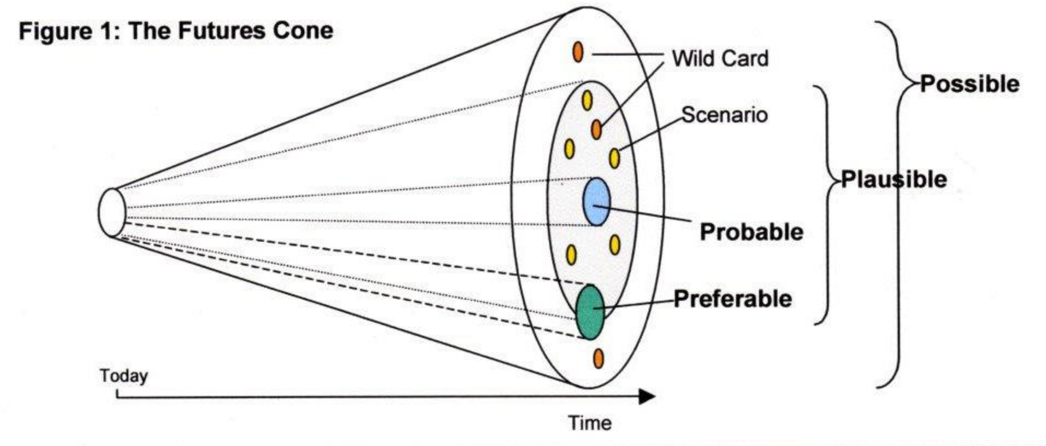
> *One way to think about my process is to view markets in terms of the* ***range of reasonable opinions.*** *The opinion that we are going to have declining and low inflation for the next decade is entirely reasonable. The opinion that we are going to have inflation because central banks have printed trillions of dollars if also reasonable.* ***While most pundits and many market participants try to decide which potential outcome will be the right one, I am much more interested in finding out where the market is mispricing the skew of probabilities. If the market is pricing that inflation will go to the moon, then I will start talking about unemployment rates, wages going down, and how we are going to have disinflation. If you tell me the markets are pricing in deflation forever, I will start talking about the quantity theory of money, explaining how this skews outcomes the other way****…. People tell stories to rationalize historical price action more frequently than they use potential future hypothese to work out where prices could be.*



Here's how to put this theory into practice:

1. **Identify the dominant beliefs driving markets**
2. **Imagine alternative future scenarios that would impact these beliefs and subsequent asset pricing**
3. **Wait for indications to see which scenario is playing out (price action helps here)**

Financial news is a great place to begin your search for dominant beliefs. But remember, you're not reading the news for facts, you're reading it to get a sense of how other players are thinking.

Journalist get their tips and leads from traders, investors, researchers, etc… They report on where the large moves in the market have *already* happened. Key word being "already". The news is backward looking. As traders, we care about the future, not the past. By the time reports start hitting the papers, especially the front page, they've long been priced in.

This is key to remember. If you're reading about a trend or market development on the front page of the newspaper, or in a big story in Barron's, chances are it's already priced into the market.

When you see this happen, your job is to start asking *"What if?"*

For example, last October the dominant financial news story was about the inevitable blowup of Deutsche Bank. You couldn't read the WSJ, FT, or any investment blog without hearing pundits warn about every reason DB would soon fail.

This extreme scenario became increasingly priced into DB's stock price. The stock fell 70% from where it was a year prior.

When you saw this broad market consensus develop, all you had to ask was "what if?"

What if the market is overpricing the likelihood of this event. Maybe DB is a bad bank but *what if* it manages to continue being a bad bank for a very long time and never actually blows up. *What if* the market regulators (ie, central bankers and government officials) who are reading the same doomsday news as you, become compelled to act? *What if* they promise to backstop and recapitalize the bank?

Clearly there were many alternate and equally probable future outcomes for DB other than its inevitable blow up. And many of these alternate scenarios were actually quite bullish for the stock. But the market was only pricing in one of these at the time; the doomsday scenario.

To *play the player*, all you had to do was ask these *what if* questions and then wait to see how price action and fundamentals unfolded.

When there's consensus it means there's a singular belief driving market pricing. That belief can quickly become overly discounted. And when something becomes overly discounted, it means it wouldn't take much contrary evidence to flip people's belief and drastically move prices.

Deutsche Bank is now over 50% higher than its lows and the dominant belief has transitioned. It's gone from one of doom and gloom to more dispersed beliefs that tilt bullish, but are far from a broad consensus.

Another prime example is oil in 2014.

In early 2013, I remember going to a "peak oil" lecture given by a very respected academic. For a number of years it became somewhat of a consensus view that we were nearing peak oil supplies and that the earth's reserves would inevitably decline.

I remember the lecturer making a very compelling case that in just a decade's time skyscrapers would no longer be in use. Energy would be so expensive that we wouldn't have the means to power common things like elevators or air conditioning.

Laughable right? But at the time this was a serious belief that was being debated by many "experts". Triple digit prices as a floor for oil were all but given. The real question at the time was, how long until oil goes over $1,000bbl?

Of course we all know how that played out.

Right around that time fracking was developed. All of a sudden we were able to pull vast amounts of new energy from the ground, even as the "peak oil" belief dominated markets. This belief was completely baked into the price at around $100bbl. It didn't take a genius to ask the right *what ifs* to uncover this HUGE mispricing and asymmetric opportunity.

2014 still remains my most profitable year. I used my *play the player* framework to short oil and go long the dollar. These trades paid out the easiest and most consistent double digit monthly gains I've ever had. And while I was minting money, other traders got crushed. They were getting played…

This is how the market works. To quote market wizard Bruce Kovner, "One of the traders I know does very well in the stock index markets by trying to figure out how the stock market can hurt the most traders. It seems to work for him."

The stock market works to transfer money from the many to the few.

The few are the traders like us who identify and exploit market prices dominated by narrow singular beliefs and consensus views.

To *play the player* simply ask yourself, where is most consensus driven trade in the market? And does it make sense to take the other side?

This simple strategy will put you on the right side of the most asymmetric trades available in the market.

Do you see how different *playing the player* is compared to the average investor trying to "value" an asset? This is what we mean when we talk about playing the markets on the 2nd level and above. Playing with this meta-understanding gives us a vantage point other traders don't have. They're the pawns and we're the grandmasters viewing the chess board from far above. This is how we win year after year.

My hope is that this strategy will put you on the winning side as well. And of course our team at Macro Ops will be here to help you along the way…

Any questions or thoughts on *playing the player* so far? Just hit reply to this email and let me know. I'd love to chat.

Your Macro Operator,

Alex

PS — I know that was a long email… but there's a lot to go over! Just to make sure you didn't miss anything *(you need to understand this concept for the next stuff I'm sending you)* here's a quick summary of the key concepts I want you to take away from this email:

1. Markets are the result of an aggregation of various individuals' beliefs. The average of these beliefs sets market prices.
2. To *play the player*, all we need to do is sniff out the most dominant, consensus beliefs and exploit them.
3. This process involves 3 steps:
    1. Identify the dominant beliefs driving markets
    2. Determine alternative future scenarios that would impact these beliefs and subsequent asset pricing
    3. Wait for indications to see which scenario is playing out by using price action
4. Reading the financial news is a great way to get a sense of how other players are thinking which informs you of the dominant market belief
5. To *play the player,* ask *what if* the consensus market belief is wrong and then wait to see how the price action and fundamentals unfold