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Austrian Investing *in a*  
Distorted World

FOREWORD BY RON PAUL

MARK SPITZNAGEL

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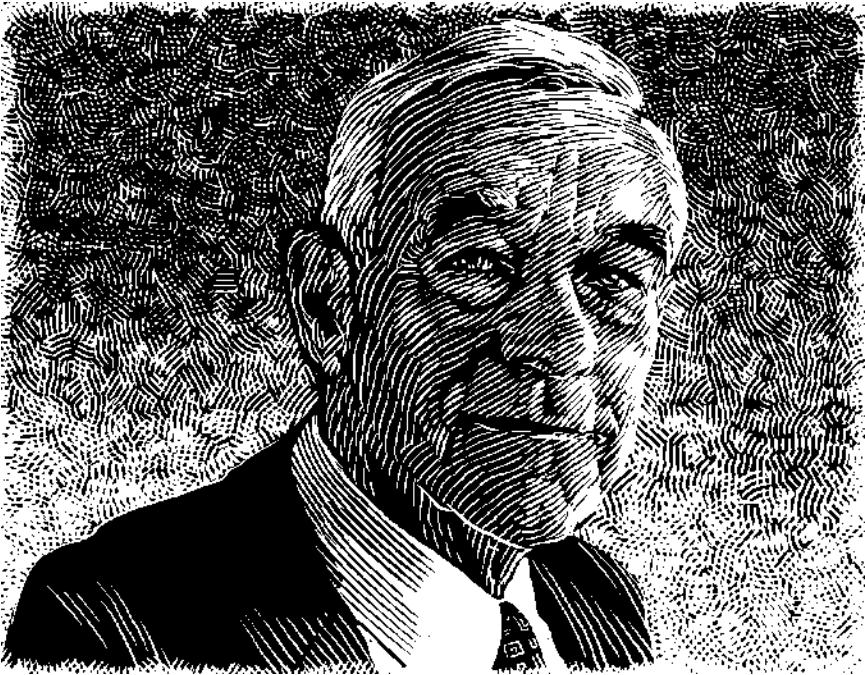
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The Sage and the Apprentice—at the Chicago Board of Trade with  
Everett Klipp (c. 1994)





# Chapter One

## *The Daoist Sage* *Klipp's Paradox*

“**Y**ou’ve got to love to lose money, hate to make money, love to lose money, hate to make money. . . . But we are human beings, we love to make money, hate to lose money. So we must overcome that humanness about us.”

This is “Klipp’s Paradox”—repeated countless times by a sage old Chicago grain trader named Everett Klipp, and through which I first happened upon an archetypal investment approach, one that I would quickly make my own. This is the *roundabout* approach (what we will later call *shi* and *Umweg*, and ultimately *Austrian Investing*), indeed central to the very message of this book: Rather than pursue the direct route of immediate gain, we will seek the difficult and *roundabout* route of immediate loss, an intermediate step which begets an advantage for greater potential gain.

This is the age-old strategy of the military general and of the entrepreneur—of the destroyer and of the very creator of civilizations. It is, in fact, the logic of organic efficacious growth in our world. But when it is hastened or forced, it is ruined.

Because of its difficulty it will remain the circuitous road least traveled, so contrary to our wiring, to our perception of time (and virtually impossible on Wall Street). And this is why it is ultimately so

effective. Yet, it is well within the capability of investors who are willing to change their thinking, to overcome that humanness about them, and follow *The Dao of Capital*.

How do we resolve this paradox? How is it that the detour could be somehow more effective than the direct route, that going right could be somehow the most effective way to go left? Is this merely meant to confuse; empty words meant to sound wise? Or does it conceal some universal truth?

The answers demand a deep reconsideration of time and how we perceive it. We must change dimensions, from the *immediate* to the *intermediate*, from the *atemporal* to the *intertemporal*. It requires a resolute, forward-looking orientation away from what is happening now, what can be seen, to what is to come, what cannot yet be seen. I will call this new perspective our *depth of field* (using the optics term in the temporal rather than the spatial), our ability to sharply perceive a long span of forward moments.

This is not about a shift in thinking from the short term to the long term, as some might suppose. Long term is something of a cliché, and often even internally inconsistent: Acting for the long term generally entails an immediate commitment, based on an immediate view of the available opportunity set, and waiting an extended period of time for the result—often without due consideration to or differentiation between intertemporal opportunities that may emerge during that extended period of time. (Moreover, saying that one is acting long term is very often a rationalization used to justify something that is currently not working out as planned.) Long term is telescopic, short term is myopic; depth of field retains focus between the two. So let's not think long term or short term. As Klipp's Paradox requires, let's think of time entirely differently, as *intertemporal*, comprised of a series of coordinated "now" moments, each providing for the next, one after the other, like a great piece of music, or beads on a string.

We can further peel away Klipp's Paradox to reveal a deeper paradox, at the very core of much of humanity's most seminal thought. Although Klipp did not know it, his paradox reached back in time more than two and a half millennia to a far distant age and culture, as the essential theme of the *Laozi* (known later as the *Daodejing*, but I will refer to it by its original title, after its purported author), an

ancient political and military treatise, and the original text and summa of the Chinese philosophy of Daoism.

To the *Laozi*, the best path to anything lay through its opposite: One gains by losing and loses by gaining; victory comes not from waging the one decisive battle, but from the roundabout approach of waiting and preparing now in order to gain a greater advantage later. The *Laozi* professes a fundamental and universal process of succession and alternation between poles, between imbalance and balance; within every condition lies its opposite. “This is what is called the subtle within what is evident. The soft and weak vanquish the hard and strong.”<sup>1</sup>

To both Klipp and the *Laozi*, time is not exogenous, but is an endogenous, primary factor of things—and patience the most precious treasure. Indeed, Klipp was the Daoist sage, with a simple archetypal message that encapsulated how he survived and thrived for more than five decades in the perilous futures markets of the Chicago Board of Trade.

## THE OLD MASTER

Daoism emerged in ancient China during a time of heavy conflict and upheaval, nearly two centuries of warfare, from 403 to 221 BCE, known as the Warring States Period, when the central Chinese plains became killing fields awash in blood and tears. This was also a time of advancement in military techniques, strategy, and technology, such as efficient troop formations and the introduction of the cavalry and the standard-issue crossbow. With these new tools, armies breached walled cities and stormed over borders. War and death became a way of life; entire cities were often wiped out even after surrender,<sup>2</sup> and mothers who gave birth to sons never expected them to reach adulthood.<sup>3</sup>

The Warring States Period was also a formative phase in ancient Chinese civilization, when philosophical diversity flourished, what the Daoist scholar Zhuangzi termed “the doctrines of the hundred schools”; from this fertile age sprung illustrious Daoist texts such as the *Laozi* and the *Sunzi*, the former the most recognized from ancient China and one of the best known throughout the world today. Its attributed author, translated as “Master Lao” or “The Old Master,” may or may not have

even existed, and may have been one person or even a succession of contributors over time.

According to tradition, Laozi was the keeper of archival records for the ruling dynasty in the sixth century BCE, although some scholars and sinologists maintain that the Old Master emanated from the fourth century BCE. We know from legend that he was considered to have been a senior contemporary of Kongzi (Confucius), who lived from 551 to 479 BCE, and who was said to have consulted Laozi and (despite being ridiculed by Laozi as arrogant) praised him as “a dragon riding on the winds and clouds.”<sup>4</sup> Furthermore, written forms of the *Laozi*, which scribes put down on bamboo scrolls (mostly for military strategists who advised feuding warlords), are likely to have been derivatives of an earlier oral tradition (as most of it is rhymed). Whether truth or legend, flesh and bones or quintessential myth, one person or many over time, the Old Master relinquished an enduring, timeless, and universal wisdom.

To most people, it seems, the *Laozi* is an overwhelmingly religious and even mystical text, and this interpretive bias has perhaps done it a disservice; in fact, the term “Laoism” has been used historically to distinguish the philosophical *Laozi* from the later religious Daoism. Recently, new and important translations have emerged, following the unearthing of archeological finds at *Mawangdui* in 1973 and *Guodian* in 1993 (which amounted to strips of silk and fragments of bamboo scrolls), providing evidence of its origins as a philosophical text<sup>5</sup>—not mystical, but imminently practical. And this practicality relates particularly to strategies of conflict (specifically political and military, the themes of its day), a way of gaining advantage without coercion or the always decisive head-on clash of opposing forces. *The Dao of Capital* stays true to these roots.

The *Laozi*, composed of only 5,000 Chinese characters and 81 chapters as short as verses, outlines the *Dao*—the way, path, method or “mode of doing a thing,”<sup>6</sup> or process toward harmony with the nature of things, with awareness of every step along the way. Sinologists Roger Ames and David Hall describe the *Dao* as “way-making,” “processional” (what they call the “gerundive”), an intertemporal “focal awareness and field awareness”—a depth of field—by which we exploit the potential that lies within configurations, circumstances, and systems.<sup>7</sup>

The central concept permeating the *Laozi* is referred therein as *wuwei*, which translates literally as “not doing,” but means so much more; rather than passivity, a common misperception, *wuwei* means noncoercive action—and here we see the overwhelming *laissez-faire*, libertarian, even anarchistic origins in the *Laozi*, thought by some to be the very first in world history<sup>8</sup> (as in “One should govern a country as one would fry a small fish; leave them alone and do not meddle with their affairs”<sup>9</sup>—a cardinal Laozi political credo most notably invoked in a State of the Union address by President Ronald Reagan). The *Laozi* also has been deemed a distinctive form of teleology, one that emphasizes the individual’s self-development free from the intervention of any external force. This leads to the paradox of what has come to be known as *wei wuwei* (literally “doing/not doing,” or better yet “doing by not doing,” or “do without ado”<sup>10</sup>). “One loses and again loses / To the point that one does everything noncoercively (*wuwei*). / One does things noncoercively / And yet nothing goes undone.”<sup>11</sup>

In *wuwei* is the importance of waiting on an objective process, of suffering through loss for intertemporal opportunities. From the *Laozi*, “Who can wait quietly while the mud settles? Who can remain still until the moment of action?”<sup>12</sup> It appears as a lesson in humility and tolerance, but, as we wait, we willingly sacrifice the first step for a greater later step. In its highest form, the whole point of waiting is to gain an advantage. Therefore, the apparent humility implied in the process is really a *false humility* that cloaks the art of manipulation; as French sinologist François Jullien noted, “the sage merges with the manipulator,” who, in Daoist terms, “humbles himself to be in a better position to rise; if he withdraws, he does so to be all the more certainly pulled forward; if he ostensibly drains away his ‘self,’ he does so to impose that ‘self’ all the more imperiously in the future.”<sup>13</sup> This is the efficacy of circumvention camouflaged as suppleness. And in this temporal configuration is, in the words of Ames and Hall, the *Laozi*’s “correlative relationship among antinomies”:<sup>14</sup> With false humility we deliberately become soft and weak now in order to be hard and strong later—the very reason that, in the *Laozi*, “Those who are good at vanquishing their enemies do not join issue.”<sup>15</sup>

In this sense, the *Laozi* can simply be seen as a manual on gaining advantage through indirection, or turning the force of an opponent against him, through “excess leading to its opposite.”<sup>16</sup>

## THE SOFT AND WEAK VANQUISH THE HARD AND STRONG

Perhaps the most tangible representation of *wuwei* can be seen in the interplay of softness and hardness in the Chinese martial art *taijiquan*—not surprising as it is a direct derivative of the *Laozi*. According to legend, *taijiquan* was created by a thirteenth-century Daoist priest, Zhangsanfeng. Cloistered on Wudang Mountain, he observed a clash between a magpie and a serpent, and suddenly fully grasped the Daoist truth of softness overcoming hardness.<sup>17</sup> The serpent moved with—indeed, complemented—the magpie, and thus avoided its repeated decisive attacks, allowing the snake to wait for and finally exploit an opening, an imbalance, with a lethal bite to the bird. In this sequential patience, retreating in order to eventually strike, was the *Laozi*'s profound and unconventional military art:

There is a saying among soldiers:  
I dare not make the first move but would rather play the guest;  
I dare not advance an inch but would rather withdraw a foot.

This is called marching without appearing to move,  
Rolling up your sleeves without showing your arm,  
Capturing the enemy without attacking,  
Being armed without weapons.<sup>18</sup>

Like Daoism itself, *taijiquan* has drifted into the more mystical and new age, but its roots remain in its martial application; this is clear today in the powerful blows of the original *Chen style taijiquan* form, as still practiced in Chen Village (located in Henan province in central China). According to Chen Xin (among the lineage of the eponymous Chen clan) in his seminal *Canon of Chen Family Taijiquan*, a deceptive rotational and circular force—known as “silk reeling”—is “the main objective of Taijiquan moves, which work on the centrifugal principles of a ‘roundabout’.”<sup>19</sup> The rotation is between retreating and advancing, between soft and hard. (When performed by a master, such as my teachers Qichen Guo and Jwing-Ming Yang, of whose *qinna* maneuvers I have oft found myself on the wrong end, it is most unsettling, almost deplorable in its artful deceitfulness.)

*Taijiquan* is a physical manifestation of the importance of waiting and exploiting another's urgency through softness in a clash. This is most apparent in the two-person *taijiquan* competitive exercise known as *tuishou*, or "push hands," in which two opponents engage in what looks to the casual observer like a choreographed series of synchronized movements. In actuality *tuishou* is a cunning contest with highly constrained rules, in which each tries to throw the other to the ground (or outside a boundary) during a sequence of subtle alternating feints and attacks. The real force is not in the pushing, but in the yielding. (In *tuishou* is an ideal roundabout and investing metaphor, one that I will return to again and again.)

The "Song of Push Hands," in its oral transfer of the art over centuries in Chen Village, instructs the competitor to "guide [the opponent's] power into emptiness, then immediately attack."<sup>20</sup> To guide or lure the opponent into emptiness and thus destroy his balance is the very



Tuishou: Zouhua and Niansui

indirect objective—to gain the position of advantage—to be followed by the direct objective of attack. This is the essential *tuishou* sequence of yielding, neutralizing, and sticking. Yielding and neutralizing—*zou* or *zouhua*, “leading by walking away”—is the sneaky retreating rout, followed by converting and redirecting a force to advantage; that advantage is exploited by sticking and following—*nian* or *niansui*—and thus eventually advancing back in a decisive counterattack. (Taken together, as we will see in Chapter 3, this sequence describes *shi*, the strategy of *wuwei*.)

The competition is a subtle interplay of delusive complementary—not opposing—forces between opponents, between hard and soft, each seeking the shrewd strategy of patiently attacking the balance rather than the force, of going right in order to ultimately go decisively left.

This is also the insidious strategy of guerilla warfare. While used effectively, for instance, by the scrappy American colonists against the British in the eighteenth century, it was later used deftly against the mighty United States by the far weaker and smaller Vietcong in the twentieth century, the very same alternating intertemporal softness and hardness: When the U.S. troops surged, the Vietcong retreated in a rout into the mountains (*zouhua*), drawing the U.S. troops out until overextended; then the Vietcong counterattacked, following the U.S. troops (*nian*) in a destructive counterrou. The great frustration—the unfairness—is that the harder you push, the harder you fall. Chairman Mao knew these words from the *Laozi*: “If a small country submits to a great country / It can conquer the great country. Therefore those who would conquer must yield / And those who conquer do so because they yield.”<sup>21</sup> (We will encounter this again with the guerilla warriors of the north in the Epilogue.)

In the *wuwei* of *taijiquan*, the advantage comes not from applying force but from circular yielding, from directing the course of events rather than forcing them; from the *Laozi*, “Hence an unyielding army is destroyed. An unyielding tree breaks.”<sup>22</sup> The patience of the intermediate steps of loss and advantage defeats the impatience of the immediate gain; the direct force is defeated by the counterforce. Thus there are always two games being played in time, one now and one later, against two different opponents. As the great *tuishou* practitioner Zheng Manqing observed, one must first “learn to invest in loss” by leading “an opponent’s force away so that it is useless,” and which will “polarize into



its opposite and be transformed into the greatest profit.”<sup>23</sup> In *taijiquan* is the essence of *The Dao of Capital*.

So much of waiting and ignoring present circumstances, of willingness to be in an uncomfortable place, is *understanding* the sequential instead of only *seeing* the immediate. There is a definite brand of epistemology at the root of the *Laozi*. To the *Laozi*, much of the exterior world is but exterior diversion, much perception is a distraction from a hidden reality—though one which requires diligent attention. It states this most succinctly in “Venture not beyond your doors to know the world / Peer not outside your window to know the way-making. . . . The farther one goes / The less one knows.”<sup>24</sup>

Paul Carus, in his definitive 1913 *The Canon of Reason and Virtue: Being Lao-tze's Tao Teh King*, went so far as to relate this epistemology of the *Laozi* to eighteenth-century German philosopher Immanuel Kant: The *Laozi* “endorses Kant’s doctrine of the *a priori*, which means that certain truths can be stated *a priori*, viz., even before we make an actual experience. It is not the globe trotter who knows mankind, but the thinker. In order to know the sun’s chemical composition we need not go to the sun; we can analyze the sun’s light by spectrum analysis. We need not stretch a tape line to the moon to measure its distance from the earth, we can calculate it by the methods of an *a priori* science (trigonometry).”<sup>25</sup>

Indeed, there is an almost antiempirical vein to the *Laozi*, a stand against the *positivist* view of knowledge as exclusively flowing from sense perceptions. As Jacob Needleman interprets the *Laozi*, “We see only things, entities, events; we do not directly experience the forces and laws that govern nature.”<sup>26</sup> Similarly, Ellen Chen says the *Laozi* “is not pro-science in spirit,” “repudiating the knowledge of the many as not conducive to the knowledge of the one”<sup>27</sup> (thus invalidating *induction*). Truth is learned from understanding basic natural and logical constructions, a tree that bends to the force of a wind, pent-up water that eventually destroys all in its path, the interplay between snake and bird. There is much deception in appearance, the tyranny of the senses, of empirical data—wisdom that gains particular context and meaning in investing.

## INTO THE PIT

My exposure to investing came quite by accident. As a 16-year-old (whose only previous experience with markets was through a share in

the Rochester Red Wings minor league baseball team, passed down proudly for three generations) I tagged along with my father when he paid a visit to his good friend (and corn futures trader, whatever that was) Everett Klipp at the Chicago Board of Trade. I stood in the visitors' gallery overlooking the grain trading pits, gaining a bird's-eye view over a kaleidoscope of bright trading jackets, flailing arms, and lurching bodies. I was expecting some kind of swanky casino (perhaps out of a James Bond film), but this was different than that. I was mesmerized. It reminded me of watching a flock of birds, a cloud of countless individual parts appearing as a single fuzzy organism, seemingly resting, hovering in midair, until something unseen starts to ripple through it like a pulse of energy, causing a sudden jolting turn in a burst of speed. The flock swoops and dives, rests, and then rises again, with a mechanical yet organic coordination and precision, while the outside observer can only marvel at its driver. In the pit was the same mystery, with pauses interrupted by sudden cascades of noise and energy driven by something imperceptible. It was a financial *Sturm und Drang*, but within it was an unmistakable, intricate communication and synchronization. In an instant, I scrapped my hard-won Juilliard plans (needless to say, my mother was horrified) and wanted nothing more than to be a pit trader.

After that fateful trip, I became obsessed with the grain futures markets. Price charts soon lined my bedroom walls and I constructed a potted corn and soybean plant laboratory (with seedlings lifted from local farms in the dark of night) for monitoring rainfall and crop progress. From then on, whenever I would see Klipp I always peppered him with questions (often with handy graphs and USDA reports in tow) on price trends, world grain supplies, Soviet demand, Midwest weather patterns—basically on where the markets were headed. His response was always a variation on: “The market is a completely *subjective* thing, it can do anything. And it is always right, yet always wrong!” His abject disdain for data and information left me bemused, even skeptical of this stubborn old Chicago grain man with the gravelly voice, ever speaking in fortune-cookie prose. How could he have done so well as a speculator without knowing—or even caring—where the market was heading? How could it be that “guys who know where the market is heading are no longer at the Board of Trade. They are either retired or broke. And I can't think of any that are retired.” Classic Klipp.

If trading wasn't about predicting price movements, then what was it all about? After all, profiting was buying (or selling) at one price and then eventually selling (or buying) it back at a higher (or lower) price. How could this be done without any ability to forecast? The answer, which took this teenager some time to understand, was that the edge to pit trading was in the order flow—the succession of *mini-routs*, as I always called them—and in the discipline; it was in a patient response to someone else's impatience, someone else's urgency. The edge was a process—an *intertemporal process*—an intermediate step to gain an advantage, rather than any direct analytical acumen or information. And its monetization—its roundabout production—required time.

The bond pit was where the real action was (and where the average trader's age was perhaps twenty to thirty years below that in the corn pit). When it came time to ask Klipp what to study in college to best prepare me for a career in the bond pit, he advised, "Anything that won't make you think you know too much" (alas, my economics major would have to remain a dirty secret). During summers and over holiday breaks from college (where I can recall always carrying around a copy of the book *The Treasury Bond Basis*, still stubbornly trying to ready myself for trading) I worked as a lowly clerk for a few of Klipp's traders. Finally, after graduating, with backing from Gramma Spitznagel (my first and best investor) I leased a membership at the Chicago Board of Trade and took my place in the bond pit where, at age 22, I became its youngest trader.

The deliverable instrument of the bond futures contract is the 30-year U.S. Treasury bond (or a nearby "cheapest to deliver"), the benchmark interest rate (along with the 10-year) on which long-term debt is based. In the early-1990s, the bond futures pit was the center of the financial universe, the most actively traded contract and the locus of open outcry in all the world. The pit was where anyone with long-term dollar-denominated interest rate risk in the future converged to hedge their rates, whether savers worried about forward rates falling or borrowers concerned about forward rates rising.

Trading pits are configured like concentric rings (octagons, actually) that descend like a staircase, resembling an inverted tiered wedding cake. The very top, outer step of the bond pit was occupied by the biggest and baddest traders (as this was where the biggest brokers with the biggest order flow stood, as well as where the best sight lines were into

the pit—an incalculable advantage). In my first month, I was decidedly not there. In fact, I was at the other extreme, at the very bottom of the pit where only the back month contracts sporadically traded.

For the first month or so, my day started and ended with Klipp standing next to me, feeding me trades and testing to see how I managed them. Klipp made it perfectly clear: “You’re not here to make money, you’re here to learn how to trade. If you could walk into the pit to make money, you wouldn’t even be in here. You’d be in a long line all the way down LaSalle Street, still waiting to get in.” This was an imminently roundabout start down a roundabout path.

## THE PRIVILEGES OF A TRADER

Klipp’s methodology was exceedingly simple—almost dubiously so—conveyed as a parent would to a child, not as principles, but as privileges: “As a pit trader, you have two privileges and two privileges only: One, you can demand the edge—buy at the bid price, sell at offer price; two, you can give up that edge when you’ve made a mistake.”

The “edge” of Klipp’s allotted privileges is that of the market makers, known as “locals” at the Chicago Board of Trade. (The bond pit was occupied by both locals, virtually all of whom, like me, traded independently for their own accounts, and brokers, whose job was to execute orders on their clients’ behalf.) What locals do is provide *immediacy* to those who demand it, meaning they offer prices (a bid price and an ask price) at which they are willing to transact immediately, and in so doing they provide immediate liquidity. In exchange, the locals require a price concession, reflected in their bid and ask prices, a profit they expect to monetize as demands for immediacy flow in from both sides, from buyers as well as sellers. Locals stand in the pit all day waiting for that flow, specifically to trade against an impatient counterparty. It’s not up to the locals to determine when they trade; rather, they wait and, if necessary, wait some more.

The price concessions, the “rents” extracted from urgent counterparties (who pay for not having to wait), are the local’s ultimate edge. But, upon receiving such a price concession, the local’s game is not over; he has the advantage, but he must act yet again, either by stepping aside (taking his loss) or following the market back. He accumulates

inventory (a position) by transacting against urgent order flow, with the intention of closing out of that inventory profitably once the urgency subsides; thus, advancing seems to be receding, and the local advances by retreating. But, naturally, between these two steps is the potential for great loss—the cost of waiting and holding inventory. So the sooner he gets out the better, but in so doing his aim is to transact better than his urgent counterparty, from whom he received his position in the first place. The late legendary bond local Charlie DeFrancesca (“Charlie D.”) put it best: “The question is: Can you be more efficient than the market?”<sup>28</sup>

Klipp liked to think about the local’s role in more standard business terms, such as the inventory markup of the wholesaler or the retailer, or, more generally, the price spreads that exist in different phases of production for any economic good (including futures contracts). Both involve exploiting intertemporal imbalances between raw material and output, providing immediacy to end users, and the intermediation of waiting, carrying intermediate inventory (including capital goods and other factors of production), and providing a final good at just the right time and place (and, as we will see in Chapter 5, the more roundabout this process, typically the greater these spreads).

The second allotted privilege was “cruel,” as Klipp would say, because it meant immediately closing out a trade once it turned negative (a “mistake”), what he called “always taking a one-tick loss.” One could expect this to happen roughly half of the time, and much of the other half of the time (depending, of course, on how quickly any profits were grabbed, as we’ll discuss) the price would find its way back to show a loss even then as well.

For instance, if the market was three bid, four offered (meaning 115 and 23/32nds bid, offered at 115 and 24/32nd), I had to buy at three or sell at four—“demand the edge”—without exception. If I managed to buy a one-lot (or one contract) at three, and then a big sell order came in and pushed the market down one tick to two bid, three offered, I was expected to immediately sell that one-lot to someone at two (“give up the edge,” or “step out,” preferably to a broker who would later return the favor), thus taking my one-tick loss (which amounted to \$31.25 on one \$100,000 bond contract). I was officially in Klipp’s *Alpha School of Trading*, as everyone called it, after the name of his firm, Alpha Futures. (We were the guys in the aqua jackets who loved to lose money.)

Who could argue with this logic? If, as Klipp said, “There’s only one thing that can hurt a trader at the Chicago Board of Trade, and that’s a big loss,” then, for God’s sake, “never take a big loss.” As his own mentor said to him some 40 years before, “Any time you can take a loss, do it, and you will always be at the Chicago Board of Trade.” (To which Klipp always added with a smile, “Well, I’ve been losing money since 1954, but he was right, I’m still at the Chicago Board of Trade.”) Naturally, this meant taking many small losses. Hence you had to “love to lose money,” otherwise you’d just stop doing it.

Impatience and intolerance for many such small losses, as well as urgency for immediate profits, Klipp believed, dealt a death blow to traders, an easy and common one. The well-known *disposition effect* in finance, an observation that goes back at least a century, states that people naturally fall victim to these tendencies, and thus do the opposite of Klipp’s approach: We sweat through large losses and take small profits quickly. Going for the immediate gain *feels* so right, while taking the immediate loss *feels* so wrong. The pressing need for consistent and immediate profits is hardwired into our brains; we humans have a shallow *depth of field* (as we will see in Chapter 6).

And nothing is better at amplifying this natural humanness about us than trading too big and having excessive carrying costs. These are the great external magnifying lenses on the immediate. All is decisive when all is at stake, whether through an excessive loss (because of too much leverage)—a loss that you can’t afford to take immediately—or an insufficient gain (because of too much debt). No one trade need ever be decisive. As Klipp said, “One trade can ruin your day. One trade can ruin your week. One trade can ruin your month. One trade can ruin your year. One trade can ruin your career!”

It is not surprising, then, that Klipp’s approach was not embraced by everyone, even by most; in fact, in many ways he was pit trading’s greatest dissident (despite his title, bestowed by the futures industry, of *The Babe Ruth of the Chicago Board of Trade*). Among his greatest critics was none other than Charlie D.—the misinterpretation of whose criticism surely cost many an aspiring Charlie D. his shirt. (There will only ever be one Charlie D.) It was nearly impossible to follow and practice consistently—“brutal” was Klipp’s term to describe the formidable challenge of looking beyond the immediate outcome—of retaining *depth of field*—a challenge that Klipp believed was essential to gaining an edge.

This was as it should be; indeed, if everyone accepted Klipp's Paradox, it would no longer be effective, no longer even be a paradox. From the *Laozi*, "The bright path seems dim / Going forward seems like retreat / The easy way seems hard / The highest Virtue seems empty."<sup>29</sup> Here are the favorite Daoist images of water and the valley, the *Laozi*'s "attitude of lowliness,"<sup>30</sup> which water always seeks.

This was Klipp's roundabout approach, and that of his mentor and perhaps his before: Expect to lose first, the first loss is a good loss; from that comes greater gain later. Call it playing good defense, embracing loss, biding one's time and using the present moment for later advantage, the advantage of then playing more effective offense. Or, as Klipp called it, "looking like a jerk, feeling like a jerk." Waiting must precede opportune action, by definition. Exploiting others' immediacy was the logic of the roundabout approach, the fundamental edge—the ultimate edge of trading and investing.

In baseball the difference between minor leaguer and major leaguer is generally thought to be in hitting the curve ball, as opposed to just a linearly extrapolated fast ball, and so too is the difference in investing in playing the curve, the roundabout intertemporal bends which deviate from the straight course. My mantra has always been like that of Milwaukee Braves pitcher Lew Burdette, who once said, "I earn my living from the hungriness of hitters."<sup>31</sup> I earn my living from the hungriness of investors, from their decisiveness, their forcefulness, from their great urge for immediacy. And this immediacy was not just the bid-ask spread; it was even more so, as we will see, in the larger routs.

## **ROBINSON CRUSOE IN THE BOND PIT**

After about a month, Klipp released me into the wilds of the active bond contract, the upper steps. The discipline had to remain the same—I still had but two privileges—and, like a hawk, he kept an eye on me in the pit as well as on my daily trading statements, to make sure that it did.

The king of the bond pit, nay of all pits, was (and will forever be) Lucian Thomas Baldwin III (trading badge "BAL"), known for the largest trading size of any local—thousands of contracts a day—and his ability to single-handedly bully what was then the half-trillion-dollar government bond market. While I was still a teenager, at a time when

most in Chicago idolized M.J., I idolized BAL. As a clerk in the pit, I intently studied his trading. He was a man possessed (which perhaps explained his unfortunate and notorious pencil-stabbing pit incident), but what was so astounding about him was his disciplined control in alternating between tremendous patience and overwhelming aggression.

So naturally I had to pick a spot in the pit near BAL's. He took one look at my fresh face and "SIZ" trading badge and branded me forever "The Sizzler," and made me his personal spitball target. But if I had to be hazed during my start as a pit trader, I was honored that it was by the greatest of all time (and it was something of a rite of passage when he stopped lobbing spitballs and started trading with me).

Venturing into the upper steps of the bond pit was like suddenly getting shipwrecked on a deserted island, all alone and with little access to order flow. I was the Robinson Crusoe of the bond pit. This apt metaphor (the solitary islander who devises a range of strategies for survival amid scarcity, the protagonist of Daniel Defoe's 1719 novel) runs deeper; it has become a quintessential economic parable—used most notably by the Austrian School economists, who focused so much on the actions of the individual in exchanging one state of affairs for another (what they called "autistic exchange"), but going back at least as far as Adam Smith, himself. (Crusoe's simple act of making a crude fishing pole and later sacrificing the time to construct a boat and net, tools by which he becomes more productive, will become integral to our roundabout concept in Chapter 5.)

Klipp had given me the equivalent of a pole with which to catch fish, but that was it. I endlessly cast my meager solitary line, bidding and offering one-lots, but cast after cast, more often than not the result was yet another one-tick loss (the fish stole the bait). Days sometimes passed with little to show for time spent standing and yelling in the pit; then I would hook a meal for a week.

Now, let's say Robinson Crusoe discovers, after exploring various fishing holes around his lonely island home, that at some, perhaps where the water is rather shallow, he can catch smaller fish with some frequency, and he has also discovered a few spots, perhaps where the water is very deep, where the fish are much larger, but fewer in number (and thus bite much less frequently). There is a natural trade-off for Crusoe, then, between size and frequency. This is of course a ubiquitous tradeoff in nature—and, when involving complex phenomena, is often described



in terms of a “power law” of frequency along the size continuum (or “really small things are really common, really big things less so”).

The question was: Where should Crusoe fish, or, in the trading pit, how big of a profit was I after—when to grab a winner? Answering this question was necessary to the second step in the roundabout process of pit trading.

While Klipp’s methodology, his privileges, defined the edge and the downside of monetizing that edge, it left wide open the size of the profit to wait for. He explained the size of a “good loss,” but said nothing about the size of a “good profit.” He would always say, “While there’s no such thing as taking a loss too quick, you *can* take a profit too quick—but I can’t tell you when to take a profit.” (The term “scalper” typically meant a local looking to make one tick on every trade. Klipp was the antiscalper.) With Klipp, there was no settling for minnows.

The question of profit size was, of course, not about trade size, which was a simple function of account size, and which, of course, would impact both losses and gains proportionately. This was about the size of profits *relative* to the size of losses, the *payoff*.

In Klipp’s basic asymmetric strategy, the bigger the gain I waited for, the less frequently it would occur, and the more asymmetric (or “positively skewed”) my payoff would be. For example, taking profits only after they reached ten ticks in my favor would naturally happen less frequently, and would be accompanied by more frequent losses, than after just three ticks. (I would often watch a profit of seven, eight, nine ticks come right back and become a one-tick loss. Not fun!) This could be extended to the absurd: I could shoot for hundreds of ticks, which might not happen for many years, perhaps never at all, with nothing but countless one-tick losses until then. On its own, a very potent strategy, but not necessarily very effective, in the end.

While Klipp was not a scalper, neither was his approach about hitting the jackpot on one lucky trade; it was about incremental gains, exploiting a systematic edge through time. But, indeed, as the profit objective increased, the trade became the equivalent of holding a basket of long option positions (or convex payoffs). Klipp had an intuitive understanding that the market tended to experience infrequent, large moves—what we call “fat tails,” for mass in the extremes of the frequency distribution of market returns—and that replicating such a basket, in its simplest and most elegant form, was a good way to play it.

## FISHING IN “McELLIGOT’S POOL”

As I experimented with moving from small fish to big, with decreasing frequency, I moved from the world of Defoe to that of another literary economic thinker, Theodor Geisel (otherwise known as “Dr. Seuss”). In his 1947 book *McElligot’s Pool*, a young boy coincidentally named Marco imagines all sorts of wondrous fish that he can’t see beneath a murky pond but intends to catch nonetheless. A disparaging old farmer repeatedly tells him that there are no fish in the pond, but Marco keeps trying. He casts and casts, undeterred. Marco’s bet illustrates rather aptly the second and third century CE skeptic Sextus Empiricus’s *problem of induction* (i.e., the “black swan” problem): All it would take would be one fish to prove that cynical old inductivist farmer wrong. (Marco says, defiantly, “It may be you’re right. I’ve been here three hours / Without one single bite. There might be no fish. . . . But, again, Well, there might.”) Although Marco can’t see anything in that pond, and no one has ever caught anything there before, he patiently hopes to exploit the extreme unknown that he dreams up, described in Seussian rhyme, “. . . something bigger . . . some sort of a kind of a THING-A-MA-JIGGER!! A fish that’s so big, if you know what I mean, that he makes a whale look like a tiny sardine!”<sup>32</sup>

As a young pit trader, ever squeezing my profits, indeed, I was Marco, waiting for the big unknown trophy. It turned out to be a rather productive approach for me (particularly from the limit down bond collapse of 1994), and such asymmetrical casting is a useful idea when the waters are murky, when you don’t know anything (and you don’t even know what you don’t know). But it seemed to be conflating two edges, one systematic and one fuzzy, the local’s edge and some kind of presumed underpriced tendency for large deviations. These were really very much the same, though on different scales. Indeed, all moves in the market, big and small, ultimately have immediacy at their source.

## ENTER THE AUSTRIANS: A VON KARAJAN MOMENT

Klipp was convinced that nothing from academia would be useful in the real, gritty world of financial markets. But he was unaware of a particular old school of economic thought, where hidden within its

formalized foundation was the very same foundation, not only for his Alpha School, but more broadly for a rigorous investment methodology predating and rivaling all others—though locked away by decades of neglect and never drawn out and applied. This was the great Austrian School of Economics, or the Vienna School (named after the origin of its founders), by most accounts nonexistent amid the vast majority of academic economic programs—and what better indication of the precedence of credentials over understanding the world in modern academia. So, Klipp was perhaps right in his expectation, as my collegiate exposure to the Austrians was truly the luckiest of breaks.

It started in a fortuitous economics course at Georgetown University taught by Professor George Viksnins (“Uncle George”). It is most fitting to gain the greatest insight about markets from those who fled antimarket regimes, in his case in Latvia. Uncle George’s declared favorite economist was Joseph Schumpeter, a wavering Austrian, to be sure, but close enough to pique my interest. And from there I discovered a book by Henry Hazlitt titled *Economics in One Lesson*—and if I am able to get my children to read only one economics text in their lifetime, God forbid, it would be Hazlitt’s. (In addition to the Austrian tradition’s absence from most of the top universities, it should come as no surprise that, according to my diligent research, even Austrian-friendly texts are absent from virtually all the top preparatory schools in the United States—but for one, my favorite: Cranbrook Kingswood in Michigan, where Hazlitt’s book is required reading.) *Economics in One Lesson* is an expansion on the essay, “That Which Is Seen, and That Which Is Not Seen,” by nineteenth-century French economist Frédéric Bastiat (who plays a leading role in Chapter 4 of this book). Hazlitt’s proclamation would become a central tenet for me (wherein I would equivalently swap the words “economics” with “investing” and “act or policy” with “capital and production process”): “The whole of economics can be reduced to a single lesson, and that lesson can be reduced to a single sentence: *The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy.*”<sup>33</sup> I could not put Hazlitt’s book down (and it would even replace my dog-eared *Treasury Bond Basis*).

The closing verse of Hazlitt’s book was an auspicious directive: “The reader who aims at a thorough understanding, and feels prepared for it, should next read *Human Action* by Ludwig von Mises.”<sup>34</sup> Finally, as a pit trader, I got around to complying. So there I was, trading in the

bond pit, likely the most competitive capital marketplace in the world, and being lectured to on my daily commute by its greatest acolyte (by way of the cassette version of *Human Action*).

*Human Action* is the *Laozi* of the Austrian School, the magnum opus of its central figure, a monumental economics treatise from 1949, which Mises wrote in English but which was based on his 1940 German-language *Nationalökonomie: Theorie des Handelns und Wirtschaftens*. (Mises is another case, like Uncle George, of one who evaded the destructive suppression of free markets, among other liberties, in his case the 1938 Nazi *Anschluss* in Austria.) In Mises's words, in his method, I instantly detected something unmistakably familiar, almost as if I'd heard them before. Hidden within this massive, dense, and formal work was the simplicity of Klipp's Paradox—the simplicity and elegance of the *Laozi*—yet articulated in a way that resolved it. It was a “von Karajan moment” for me, as I was struck by the same blow that the Austrian conductor Herbert von Karajan had described upon first hearing the great Arturo Toscanini conduct. (I would also gain my first understanding of roundaboutness—the circuitous pursuit of goals that is fundamental to *The Dao of Capital*—in the words of Karajan, who didn't achieve fame as a conductor until he was fifty and ultimately became the most renowned ever. In true Laozian style, Karajan secluded himself in the Austrian Alps for “quiet, concentrated study and meditation” and withdrew from the direct clash against his competitors—a feint that we will see in action with the conifers of Chapter 2. As he wrote in 1947, “For the moment, let the others decimate themselves in the Viennese battle of all against all—my time is sure to come and I await it, calm and confident”—and obsessively pouring over his tattered scores.<sup>35</sup>) Mises's lecture concluded, I immediately started over—over and over again (until my favorite sections became a tangled ball of magnetic tape).

What first stood out was the role of time in Mises's worldview. Time permeated everything; all action was a “temporal succession of events,” always of steps and “fractions of time,” the aim of which was “the removal of future uneasiness, be it only the future of the impending instant.” Acting was to relieve our insatiable “impatience and the pains caused by waiting.” And overcoming this natural urge was the necessary key to productivity—*roundabout production*—“the harvesting of the physically more abundant fruits of production processes consuming more time” and, thus, the significant “role played by taking account

of waiting time.”<sup>36</sup> (Mises rightfully credited this central notion of the roundabout to his predecessor, the great Austrian economist Eugen von Böhm-Bawerk, the subject of Chapter 5.) Degrees of impatience—what the Austrians call *time preference*, the singular source, in Mises’s view, of interest rates—in waiting and forgoing immediate profits (or consumption) and even bleeding capital (such as through costly capital expenditures), was a logical part of our humanness—indeed, part of that humanness which we had to overcome to do certain propitious things (things which cumulatively amounted to the very progress of civilization). This was Klipp’s Paradox, writ large, on the grandest scale, formalized and temporalized in the Austrian economic language.

Moreover, of most immediate concern for me (as a treasury bond trader during a period of immense monetary interventionism) was a fundamental result of Mises’s framework: Taken to its logical conclusion, a society’s time preference could not be repudiated, and the actual market rate of interest had to correspond to the underlying fundamental “originary” rate of interest. Any vain attempt to do otherwise, as when market interest rates are artificially set through monetary intervention, would mislead production and would result in an imbalance and distortion in the economy. Over time, forces would grow stronger and stronger to eliminate that imbalance, and would inevitably succeed in violently driving the artificial rate back to its natural level, and thus the scheme would come to a necessary end. This inevitable seeking of balance from an artificial imbalance, this reversion of opposites, was, to Mises, the very source of “the cyclical fluctuations of business,” “the trade cycle,” or, more precisely, the *boom and bust cycle* (the subject of Chapters 7 and 8).<sup>37</sup>

## A STATE OF REST

Underlying Mises’s observations throughout was the basic unruliness of market prices, of their inherent subjectivity—a subjectivity that stems from the perceptions, needs, tastes, and impatience of humans. As he wrote in *Human Action*, “No laboratory experiments can be performed with regard to human action. We are never in a position to observe the change in one element only, all other conditions of the event remaining unchanged. Historical experience as an experience of complex

phenomena does not provide us with facts in the sense in which the natural sciences employ this term to signify isolated events tested in experiments. The information conveyed by historical experience cannot be used as building material for the construction of theories and the prediction of future events.”<sup>38</sup> There it was, the illusory task of predicting markets using empirical data, explained as well as it ever could be.

This fundamental indeterminism led to “the method of economics,” what Mises specifically called “the method of imaginary constructions.” This was, for Mises, the singular method of *praxeology*, or the science of human action, which “cannot, like the natural sciences, base its teachings upon laboratory experiments and sensory perception of external objects.”<sup>39</sup> It required the *a priori* deductive approach to knowledge (again, endorsing Kant) by way of well-crafted *gedanken* (or thought) experiments—a better description than “imaginary,” as these constructions were often very real, just not easily observable or tractable. We might think of it as introspection as a source of knowledge in the study of human action. To Mises, these were the axiomatic building blocks of all economic insight.

Principal among Mises’s praxeological precepts (in addition to the aforementioned *time preference*) was the notion of the market’s *state of rest* (or what he called the *plain state of rest*). The state of rest is essentially an occurrence in a market when “the brokers have carried out all orders which could be executed at the market price. Only those potential sellers and buyers who consider the market price too low or too high respectively have not sold or bought.”<sup>40</sup> It is a “lull” that will end with any new initiating order in the market, any new demand for immediacy, be it in response to news or perceptions of traders, and so forth. The state of rest is an intermittent end to all immediacy, a waypoint at which order flow is exhausted by mutually advantageous exchange, and it reoccurs in the markets over and over again.

Mises added another layer to this concept with the hypothetical continuous, yet ever elusive, aim of the market, the *final state of rest*. This was the price at which all transactions continually balanced and cleared, where no change ever occurred again in a particular market—truly an imaginary construction never attained, the intended destination never arrived at. Every state of rest was the result of a searching, bargaining process, a *Preiskampf*, or “price duel” as the Austrians called it, by which the markets were guided toward the final state of rest—though,

naturally, something would change and it would never be reached. Mises's description of the market's ongoing "temporal succession of events,"<sup>41</sup> then, was of ever moving from one state of rest to another, ever estimating the inestimable final state of rest.

## GUIDING INTO EMPTINESS . . .

At times, waves of orders would buffet the bond pit like a tornado, and you could literally feel their surge in the vibrations of scrambling brokers through the floor (before the market even moved—a moment when price swings were decidedly nonrandom in the pit). During those tumults, the prices no longer reflected a balance between buyers and sellers, or, in bond futures, between savers and borrowers.

Within the bond pit, as within all markets, is an elaborate heterogeneous temporal structure, with the urgent orders at the bottom and various degrees of less urgent orders—the least direct, the most patient, the most roundabout—at the top. The orders would swirl around the pit, intolerantly pushing prices as they moved, until finally finding a temporal home, a "fill"; the errors corrected, there was a brief eerie calm, a provisional state of rest, awaiting another swell in response. This was the messy process of price discovery in the pit (an experience that is today forever lost to the world, as such pit action described here no longer exists anywhere), a succession of failed balancing acts, with the locals as fulcrum. And in the futile search for the final state of rest is the market's grand homeostasis.

Here was Mises's whole description of the market process, "always disquieted by a striving after a definite state of rest,"<sup>42</sup> with each resulting price an error around the final state price; and these errors, what Mises called "false prices," were the local's edge. The local needed to perceive as quickly as possible these false prices, the wedges between each successive state of rest and the final state, visible only in the constant entrepreneurial urge to immediately modify and correct them—through an auction process that ultimately exhausted that urgency through overcorrection. Thus the local responded to a force by guiding the price to a new imbalance, a new and brief false state of rest.

Mises's market process made explicit what was implicit in the actions of the local, who certainly did not have to understand any

Austrian economics. (As the saying goes, the only PhD that counted in the pits was “papa has dough.”) As Mises described, they had *Verstehen*, or an intuitive grasp (or “understanding”) of entrepreneurial opportunism. What mattered to the local, their *raison d’être*, was avoiding a swelling inventory, the result of one-sided urgent order flow (as in only sell orders, for instance). In avoiding this, like birds in the flock that alter their course to avoid bumping into a neighboring bird, they thus create complex and efficient dynamics in the whole, from exceedingly simple program-like individual objectives.

Markets are necessarily asynchronous, and with each new asynchronous tidbit of transactional information everyone alters their plans. And it is in ignoring this most elementary of observations that so much of modern economics fails, focusing as it does on a hopeless single *ex ante* equilibrium state where all transacting will happen, free of time. Instead, the perfectly clearing *ex post* “Dutch-auction” price—where all transactions within a period of time, if done simultaneously, would match up—is the moving target that is being repeatedly estimated in the cumulative aggregation of false prices (resulting from the processional states of rest). (Indeed, so much of Austrian Investing is about understanding and recognizing how these estimates can be wildly distorted.)

All of this occurred in the bedlam of the pit, in a succession of *mini-routs* to a succession of states of rest, something which could take many months or even years to learn to decipher in the pit, though perfectly clarified by Mises. The market was not a casino game of flashing random variables (despite untold lives still spent studying their *stochastic* properties), but an intricate coordinating and balancing price-concession process. Indeed, in Mises’s construct was that of the pit trader.

Oftentimes, this process could turn into a coordinated (certainly skirting cartel-like) manipulation, as large locals would nudge a market through and thus trigger anticipated “stop orders” (known as “running stops”)—to their positional advantage. This was basically about flushing out the immediacy hiding in the market, like a covey of quail. It could be as simple as recognizing the urgency in an order from a broker’s visible stress (and other “tells”), or just sensing the crescendos and decrescendos in the order flow as the market explored different price levels. (Here, Baldwin’s “*coup d’œil*” in recognizing the decisive moment—and his ability to wait for it—rivaled Napoleon’s.)



These are the basic machinations of market microstructure, and of any marketplace, whether human locals or high-frequency robots: an endless alternating procession of routs. And it is the art of pit trading, in leading the market into imbalance, a momentary false state of rest away from its final state. It could be subtle or violent, involving the slightest one-lot sell order at the bid price or thousands of contracts from one or many orders that send the market into a tailspin. It was the ducking and weaving of the flock, with no driver, no one in charge, only the search to exhaust and placate what was roiling it.

Here was the link between the market-maker's edge and the occasional huge moves of the market. The *major-routs* were identical to the *mini-routs*, only bigger (a property known in mathematics as *self-similarity*, or *fractal*). Specifically, they were both about imbalance seeking balance, of false prices seeking correct prices. The wedge was just bigger.

In the bond pit, order flow thus communicated and the locals thus balanced the immediate intentions expressed by marginal savers and borrowers. This meant that, in fact, when there were no urgent active orders, the economy would (when there was no artificial price setting) be in a state which Mises called *stationary* (another of his praxeological terms we will revisit in Chapter 7). (And a hypothetical final state of rest throughout an economy would provide what Mises called an *evenly rotating economy*—which we might think of as an economy in which nothing ever changes, a kind of economic Dark Ages.)

Understanding this process of liquidity is basically about understanding that any market exchange must be perceived as mutually beneficial to both parties. A failure to understand this, particularly in a market dislocation like a crash, is the source of much angst directed toward high-frequency traders, for instance, who cease their liquidity-providing activities (and thus create liquidity holes) when markets get too volatile. Why should we expect anything else? Why shouldn't the price of immediacy jump to infinity along with perceived demands for immediacy? Why should anyone be expected to accommodate a counterparty at prices that are strongly believed to be in error? After all, to assume anything else would be to assume that liquidity providers are charities.

Klipp's lectures to me as a teenager were spot-on (albeit, expressed in different terms): In ever searching for and finding a new state of rest, the market was always intermittently and provisionally right in

correcting an error, though, in never arriving at a final state of rest, in never achieving a synchronized balance in all orders for immediacy, it was always wrong. And the greater the imbalance, the more wrong it was.

## MOVING ON

Despite childhood dreams of becoming a pit trader finally realized, having moved up the steps from trading one-lots to tens and then hundreds of contracts, the time came to move on. I had been increasingly targeting larger bond price moves through options (flashed across the trading floor into the bond options pit from the bond futures pit), and my edge was increasingly moving away from that of the local. Moreover, it was early 1997, and the death knell for open outcry was being tolled by growing volume in the competing electronic trading (known at the Chicago Board of Trade as Project A).

And along with this new technology came a raging U.S. stock market, an unprecedented asset bubble clearly, from Mises, from an unprecedented monetary distortion—Greenspan had been on a loose monetary policy spree, following a Mexican debt crisis, and he inexplicably continued into President Bill Clinton's reelection.<sup>43</sup> It would end either through Greenspan applying the brakes (which seemed unlikely as he and Clinton had convinced themselves of a "New Economy" that was far from a bubble—not too hot, but just right, the "Goldilocks economy") or a capital and resource crunch applying them for him. Either way, the interest rate market was in extreme imbalance, an illusory temporary respite. Why plumb the murky depths of McElligot's Pool in the pit when whales were visible just under the surface?

I moved to Wall Street to become a proprietary trader at a primary government bond dealer (an investment house that participates directly in Federal Reserve transactions and Treasury auctions), and moved from bond futures and options to my new speciality, "midcurve" options on Eurodollar futures (or short-term options, expiring in less than a year, on forward three-month LIBOR contracts, expiring in more than a year). Naturally, the premiums for these options were then very low, and owning them allowed me to acquire a favorable position in the Eurodollar futures once the market woke up. It was just like being back in the pit: Option contracts are a means of gaining immediacy (though

conditional on a price threshold, the “strike price”); owning them provides immediacy in the routs, and hedging them (what option traders call “long gamma hedging”) can often pay for that privilege (and then some) by providing liquidity in the pit (thus earning back the price of immediacy).

It was the perfect setup for an *Austrian play*. What quickly became clear, however, was that the significance of the trade wasn't predominately in the hoped-for lump payout; it was in the advantage afforded by the timing of that payout. The interest rate shock I was targeting (either a surprise tightening, like 1994, or a surprise easing, from an inevitable credit bust) would be accompanied by a general market dislocation wherein immediacy would be in exceedingly high demand, and I would be essentially all alone in having the fresh capital to exploit it. As effective as the option trade was, it was but the prelude, an intermediate waypoint toward an even greater edge, an attack and counterattack of *tuishou*. In the option trade was the temporal coordination of capital with its most advantageous and opportune use. This was a chance encounter with roundabout investing, the key to Klipp's approach and paradox: Fishing most effectively by not even fishing at all, but rather by constructing a harpoon for later use—just in time for the appearance of a whale.

As it turned out, the markets did not rest in 1997 nor, especially, in the summer of 1998. The obvious counterattack, upon booking gains in the Eurodollar options trades, was to short the freshly blown-out “on-the-run-off-the-run” bond spread—and as it inevitably converged I would follow it right back to zero. This was a pure “flight to liquidity” distortion, as everyone demanded the more liquid bellwether bond over the off-the-run bond, amplified by the ill-fated hedge fund Long Term Capital Management paying anything to unwind that very same convergence trade. (It turns out their name was most apropos, as this spread was, with certainty, a perfectly profitable *long term* trade—a shame that profit was entirely usurped by the path, by their profoundly shallow *depth of field*.)

Of course, Greenspan continued his monetary distortion apace throughout the crises, which meant the insurgencies would continue. Indeed, the whales of '97 and '98 would be but a preparation for much bigger Thing-A-Ma-Jiggers to come. I joined Nassim Taleb in 1999 as he was launching Empirica Capital, a mutually obvious relationship from

our shared pit trading background and a shared view on the certainty of an eventual collapse in the then-bubbly U.S. stock market (and to this day there is no one with whom I more enjoy and benefit from sparring about tails). We called ourselves “crisis hunters” (we were, indeed, the first formalized tail protection firm ever)—which we duly snagged in the 2000 equity collapse. This would be the highlight of an aggregate Empirica record that, while functioning well as a tail hedge, was the lowest return period in my career, before or since (though much has been learned along the way—representing a wonderful barrier to entry as competitors come and go.) We parted ways in 2005, and I went on to form my own investment firm Universa Investments, moving beyond the basic mandate at Empirica. (After I started, Nassim joined me again but in a strictly hands-off, passive capacity.) Nassim has since gone on to do voluminous and very significant work on uncertainty, specifically the “black swan problem” (as well as his neologism *antifragility*—the convexity of Marco), which has wonderful far-reaching consequences—albeit less straightforward, I believe, for capital investment.

I show in Chapter 9 how extreme uncertainty and *black swans* are not the stories of the big stock market busts of the past century in the United States (including those during my career), and how the effectiveness of exploiting such busts, or “tail hedging,” is highly conditional on the particular environment of economic distortion. The real black swan problem of stock market busts is not about a remote event that is considered unforeseeable; it is rather about a foreseeable event that is considered remote—which I have spent the bulk of my career exploiting (and which explains the use of this moniker in some of my current partnerships).

Although I naturally employ positive-asymmetric, convex payoffs—a trite thing to say, as in the familiar “favorable risk/reward”—all the data clearly shows that most such “volatility loving” payoffs are and have been overpriced, *ex ante* (using power law tail and other rigorous valuation measures) and *ex post*; and this is why I do not apply what has come to be known as the *barbell strategy*. These bets are mostly the stuff of gamblers and financial salesmen, from nonlinear derivative securities to highly volatile equities to momentum strategies of all stripes; alone, they are a direct, frontal attack. Rather, to me, convexity is an efficient (low-risk) tool for exploiting routs of pent-up immediacy and distortion, but only under the right circumstances (as in the game of *tuishou*); and it is only a part of a roundabout strategy, an intermediate step (of *zouhua* and

nian) toward the decisive end goal of productive capital investment (the counterattack)—not the game itself. It is a tool of Austrian Investing, but not its key; that belongs to the *roundabout*, a *depth of field*, and, of course, the Austrians.

Today one of my old aqua Alpha trading jackets (stained with ink and blood) is mounted on my office wall, like a skin from some Hemingway-esque safari. Draped over it is a tattered Adam Smith necktie. From day one at the Board of Trade my uniform included this tie. Gamblers' ticks have their place, and neckties were required on the floor, but mostly I was following the example set by Uncle George, who proudly wore his with such zeal. Smith was, of course, *the* free market apostle who radically asserted its organic coordinating function; Mises himself had declared the publication date of Smith's magnum opus (*An Inquiry into the Nature and Causes of the Wealth of Nations*), falling as it did on the same year as the United States' independence, "the dawn of freedom both political and economic."<sup>44</sup> That tie was and still remains an important reminder for me that the pits—and markets in general—are not a casino, but a purposeful force, the Misesian market process at the very heart of the progression of civilization.

It was a roundabout start along a roundabout path toward the methodology of Austrian Investing, from the pit to my current investment partnerships at Universa—which started constructing Thing-A-Ma-Jigger harpoons in 2008, conveniently (though not coincidentally) put to productive use at the end of that year and into the next—and at Dao Capital (respectively comprising Austrian Investing I and II, of Chapters 9 and 10). This is our path as we follow *The Dao of Capital*.

## THE WISDOM OF THE SAGES

Legend has it that, during the Warring States Period in ancient China, as one of the seven states began to fall into decline, Laozi decided it was time to leave it behind and spend the rest of his days in solitude. As he made his way on an ox, he reached the border gate at Hangu Pass, the site of many a bloody battle; beyond was Laozi's unknown new home. As the story goes, the gatekeeper realized that Laozi was leaving for good, forever taking with him all the wisdom he possessed, and entreated the Old Master to write down his thoughts for



Laozi, "The Old Master," Retreats from the World, Leaving His Wisdom Behind

posterity. Laozi compiled and wrote down a concise treatise of some 5,000 Chinese characters.

The story, we can surmise, is fictional, perhaps much like the author himself. What is undeniable, however, is the efficacy of the words that remained, which have lasted more than two thousand years, and still echo in the wisdom of the ages: a perception of time and the preeminence of patience, a depth of field and the roundabout way of doing by not doing, and the very illusory nature of historical experience—the wisdom of an old grain trader who loved to lose money and of a great school of economic thought that would change the world forever. All would be scorned, yet all would persist, and one day come together in an archetypal investment methodology.

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