

 WILEY Trading



ONE GOOD TRADE

INSIDE THE HIGHLY COMPETITIVE
WORLD OF PROPRIETARY TRADING

MIKE BELLAFIORE

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One Good Trade

*Inside the Highly Competitive
World of Proprietary Trading*

MIKE BELLAFFIORE



WILEY

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To my Mom and Dad for their unconditional love.

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Preface

As the U.S. financial system neared the verge of collapse in the fall of 2008, a 23-year-old prop trader I know was about to pocket \$30,000 for a day's work. Rewind to 1998 when some twenty-something prop traders, discards from the big banks, were putting away more than \$10-25,000 a day without charts, CNBC in the background, a newsfeed, or even air conditioning. So what happened between 1998 and today? The Internet Boom and technical advances caused an explosion in proprietary trading but there was never a book written about it. Now there is.

During the past four years I have been growing a prop trading firm with my childhood friend, Steve Spencer. We started with nothing (not even a phone) and today our firm, SMB Capital, employs more than 60 traders. *One Good Trade* offers all the important lessons the market has taught me over the past 12 years in and around prop trading. I share these market lessons while introducing a cast of characters, some of whom have succeeded, and too many who have failed.

We will start with a look at traders to be emulated like MoneyMaker in Chapter 1, whose previous career as a professional golfer left him with a superior ability to focus, which he now uses daily to chop up the market. You will go inside this previously closed world of prop trading to learn who gets hired (classic Joe Biden story enclosed), how we trade (depends on the market), how we find the stocks we trade (you are only as good as the stocks you trade), our game-changing market fundamentals (*One Good Trade*), and our superior trading skills (It's called trading!). You will

garnish a savoring taste of what is really important to become a successful prop trader.

Trading is about skill development and discipline. Unfortunately, too many people think trading is just about making predictions, loading up, and being “the man” by holding stocks (you will meet Crabby, who predicted the whole run in oil and never made a dime as a trader). Being a consistently profitable trader is about doing the thousand little things every day - like proper preparation - that impact your P&L.

As the partner of a proprietary trading firm, I spend a great deal of my time teaching. While I still trade actively, I am mostly a trading coach. What I teach my students and have learned from my traders I will share with you. Lessons like the importance of adapting which one experienced trader, Point-and-Click, was unable to do; he now sells insurance in New Jersey.

The light I shine on the world of prop trading will include my mistakes and those of other prop traders. A great trader is an elite performer. Elite performers spend every day trying to improve. Every day we trade is an opportunity to learn from the market. My mistakes and those of other prop traders are just gifts from the market for us to improve, and they will be shared so you can learn.

My firm, SMB Capital, will be used throughout this book as an example of how prop firms operate. SMB and its traders have been featured in the TV documentary *Wall Street Warriors*, appear regularly on CNBC, and have four regular spots on StockTwits TV. It’s an entertaining place! Many of the learning experiences and anecdotes in this book come from my tenure as partner.

Too many traders do not know the stocks to trade and we will discuss how we find the Stocks In Play. Too many new

and developing traders cannot Read the Tape and we will argue how that hinders their results. Most importantly, I will walk you through this P&L-changing skill.

After a speaking engagement, I was approached by Dapper Don to explain the value a prop firm can offer and I spend a chapter answering his question. I will debunk the myth that a new trader should seek out a superstar trader to learn best. Many new and developing traders could improve their P&L if they just understood how to “Score,” and we will illuminate the importance of loss limits, ending a trading slump, and keeping excellent trading statistics.

A spot on a prop desk is a dream job for many people, yet they do not know how to succeed once they arrive. Bloomberg, CNBC, and Fox offer endless hours of professionals pontificating their opinions. Still, I know of many new and developing traders overwhelmed with information and empty with ideas to improve. We will use an old teaching technique of the head basketball coach at UCLA, John Wooden, to offer valuable suggestions in Chapter 4 (Pyramid of Success).

Along my trading and teaching journey, market fundamentals have been hammered into me by my boss, Mother Market. A trader with poor fundamentals is a ticking time bomb. That is why each trade for us is One Good Trade. At Duke University, Coach Krzyzewski yells, “Next Play” to his players. At SMB, we think One Good Trade, and then One Good Trade, and then One Good Trade. We judge each of our trades based upon whether we have followed seven fundamentals that compromise One Good Trade.

I have successfully navigated many different markets these past 12 years of trading. I will share my journey with the trading set-ups that worked best for each distinct trading period. Most importantly, I introduce the principle

that has allowed me to profit in so many different markets: I adapt.

Welcome to a trading world where you can make your own trading decisions, each day is new, your upside is unlimited, and you likely sit around some funny people. In short, prop trading to me is the very best job in the world.

For the developing traders who are underperforming and for those interested in becoming new traders in the future, this book was written for you. The market has taught me the thousands of little things required to become successful. Many are undervalued by those who have not reached their trading potential. Welcome inside the highly competitive world of proprietary trading. A funny, exciting, enthralling place only for elite performers who master all the skills demanded by Mother Market.

CAST OF CHARACTERS

There are some traders you'll get to know very well through reading this book. Traders are known for using nicknames around the office, and our office is no exception.

Mike Bellafiore, Bella
Steve Spencer
GMan
JToma
Roy Davis
Alexander James
The Enforcer
Franchise
Dr. Momentum
MoneyMaker
The Yipster

Z\$ (ZMush, Mush, Mushy, and Z)
G

In addition to their stories, you'll also hear from readers like yourself in the "Traders Ask" sections of the book. There are some questions about prop trading that I receive time and again via e-mail or the SMB Capital blog, and this will help answer some of them.

MIKE BELLAFFIORE
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PART I

Inside a Prop Trading Firm

CHAPTER 1

These Guys Are Good

I belong to the most exciting part of Wall Street that no one pays attention to. That is, until now.

The kind of trading firm I co-founded, a proprietary trading firm, is not a bailed-out government bank, a broker-dealer, or a hedge fund, though it does run on some of the same core principles as those places.

Proprietary trading firms do somewhere between 50 and 70 percent of all the equity volume on the Street on any given day. Yes you read that correctly: 50-70 percent. Brokers bank hundreds of millions on firms like ours each month in trading commissions. This money flows to the coffers of clearing firms that take no risk but enjoy the rewards of the traders' hard work. The government also makes out nicely, raking in hundreds of millions annually in SEC taxes. (I'm not complaining, just offering facts.)

To offer some background, proprietary trading exploded during the Internet Boom. When I first began trading in the late 1990s, there were only a few firms hiring recent graduates to trade. There are no exact numbers on how many proprietary trading firms exist today, but the general consensus is more than a hundred and less than three hundred. Obviously this number is now much more than the handful that existed when I first began.

Unlike most firms on the Street, proprietary firms have no clients. We do not sell a product or help someone else sell a product. We do not take other people's money and

speculate it on their behalf. A proprietary trader's after-hours schedule is not booked with dinners at New York City steakhouses like Sparks, drinks at the trendy Buddakan, or Rangers games (the Knicks are presently unwatchable). We don't need to schmooze.

We eat what we kill. Our profits are generated solely from the bets we make on our traders. When we are wrong, we lose our money. When we are right—and let me say that is a lot more fun—we keep a percentage of our winnings.

WELCOME TO THE WORLD OF PROPRIETARY TRADING

Proprietary trading (or “prop trading” for short) is done for the benefit of the company's partners and employees only, not for the benefit of any client. The firm is the client. A prop firm's traders actively speculate on stocks, bonds, options, commodities, derivatives, or other financial instruments with its own capital as opposed to customers' money.

There is no money made on insider tips at the legitimate prop firms. I wouldn't know an insider unless he walked onto my trading floor and announced, “Hey I am an insider. Get long BNI, Buffett is about to buy a stake in the company.” My news comes mainly from Internet sites like briefing.com and Bloomberg.com—sites the whole world can access. Some proprietary firms have an interest in obtaining private research from institutional banks like Goldman Sachs and they can pay for access to it. We have access to some of this data but it does not make a difference. At my firm, SMB Capital, only the floor manager has a phone (his mom calls a lot). We depend on our trading talent. We eat what we kill. I wouldn't have it any other way.

There are some months when a prop trader works 50 hours a week and takes home no money. Heck, there are some months when a trader works even harder and loses money. I spent 2002 unable to make a dime. On the contrary, there have been days that a prop trader is up over \$10k by 9:35 AM. He punches a few keys, the stock does what he thinks it will do, and he books these outsized profits faster than most drink a cup of coffee. In fact, there have been some mornings (Black Friday 1999, for example, when I sauntered onto my trading floor, turned on my computer screens, and saw that my account was up over 50k.) Now that is the way to start your morning! This is not one of those jobs where there are guaranteed contracts with a biweekly check that has the same numbers sprawled across the pay stub.

Many of the brightest of the bright leave our industry humbled (perhaps bitter?) by their inability to master the game. The smart ones figure out how to parlay their recent trading education into steady finance jobs. Juxtapose that with prop traders who make seven figures every year walking around in jeans and a t-shirt, sitting right next to overdressed bankers every morning on a downtown subway. I know it sounds unfair. But remember...in prop trading, we are the client. Would you dress up in a suit to impress yourself?

There is a very real chance that the uber bright-and-talented get sent home packing. It does not do anyone any good pretending to be a prop trader. This is just a lose/lose situation. The would-be trader loses by doing something he wasn't meant to do, and the firm loses time and capital (though other market players may wish for these suckers to stay, like dead money at a poker table). The market demands that a trader follows all of her rules, every day, and every moment. Many just cannot thrive in this unbending universe.

At a proprietary trading firm, the trader makes all of the decisions. Unlike most jobs, there is no supervisor or partner reviewing every decision before it's made. Success, for better or worse, is totally self-dependent. You determine whether a stock is more likely to go up or down and how much capital to risk. If you are correct, then the firm and you make money. Whether a trade works out or not, the results are plastered on a huge scoreboard both on your computer screen and on shared monitors, kind of like standings in the sports pages. Accountability and performance are brutally transparent.

Prop traders are not trying to beat VWAP (Volume-Weighted Average Price, or average intraday price of the stock) or fill orders for some client. For a proprietary trader, beating VWAP is about as difficult as it is for LeBron to put up 30. You are not entering orders as dictated by a portfolio manager, PM, or hedge fund manager. This is hands-on-the-wheel trading—you determine the markets and stocks to trade, the size of the trade, and the entry and exit points. Your future depends upon one thing: *your* trading ability.

If you're just starting out in prop trading, know that very soon you will be given a trading account. You'll probably be asked to complete your firm's training program first, and set some computer keys to buy and sell (hot keys), but then you're off! You won't run errands like an intern might (in which case you are on call at all hours) and you won't fill orders in the Asian markets at 2 AM. A good training program will provide critical feedback concerning your trading but *your* judgment combined with *your* trading skills will determine your future.

At a hedge fund or big bank, most would-be superstars sit on the bench for a few years before being given responsibility with live capital. And oftentimes, one cannot get a job at a hedge fund without having worked at a big

bank first. At SMB Capital, traders start with live ammo on Day 26.

Unlike in years past, when “trial by fire” was the preferred form of mentorship, today’s better proprietary trading firms have intensive training programs. A firm’s partners invest a tremendous amount of capital, time, and teaching to make sure their trainees succeed. If a trader is not successful, the firm has invested a great deal of time, energy, and capital with almost no benefit. Thus, nothing less than an outstanding training program is in the proprietary trading firm’s best interest.

Here are the best parts: compensation is practically unlimited, there are no office politics, and no subjective end-of-year performance reviews to determine a promotion or a raise or give constructive feedback like “you need to start asking for more responsibility.” Traders take stock of their performance every single day, calculating profits to the cent in real time, and taking home a percentage of the spoils. The only haggling for a “raise” comes in the form of top producers requesting to take home a higher percentage. And at some firms, the partners will invite their best young talent to join them, just like in the old days of the Wall Street investment banking partnerships. Transparency, accountability, and instant feedback . . . where else in the corporate world can you get that?

OK, here’s another “best part” of prop trading. Every day is new. Pushing papers around and doing the “same nonsense different day” is the antithesis of our job. As an example, here is how I spent Black Friday of 2009, the day after Thanksgiving, a day I was supposed to spend relaxing, watching an action movie, and eating leftovers: I awoke at 5:15 AM in Albany, New York, and prepared to take a borrowed car to the Amtrak station, then to the subway, then to my office (door to door it took me just under four

hours). I was the only one awake on Amtrak from Albany to Penn Station as I was preparing for the day's Open, trying to communicate with my partner and co-founder Steve Spencer, rip through charts, and find patterns from overseas trading that might give us an edge.

Despite my having given the firm the day off, Steve and I contacted all of our traders on the night before because of the news of Dubai defaulting on billions of its debts. (Steve is my business partner, but he's also my best friend since age six.) We reached some of the traders, but not all. We spread word to the StockTwits community, the largest social media finance network, that this Black Friday was not a session to miss. SPY was opening down huge. We might bounce, we might tank, but whatever happens could offer great opportunity. Opportunity is what sustains intraday traders (though one of our traders subsists on Burger King and candy). As I reflected on a Thanksgiving Day-stuffed stomach, I was hard pressed to remember a day that offered more potential intraday trading opportunity than this Black Friday.

As a trader, one never knows when he is going to walk into a market that rains money. Black Friday 2009 could have been that day. I would not risk missing it. So I woke up early, sacrificed time with my family and a day of recharging, and started my travails.

I patched into our firm morning meeting, which was broadcast to the StockTwits community, via a crappy \$300 netbook from a spotty wireless region. But I saw and heard Steve from my reclined seat on Amtrak offering me a game plan for this Open. I could have never done this "in the old days." What a super job by Steve and all who helped him prepare for his show running down all the key levels to watch before the Open. But then he said something that

mattered most of all. Steve introduced the idea of market psychology.

The news before the Open was not good. Asia had digested the Dubai news and showed signs of food poisoning. The Asian markets got hammered and our markets were poised to open supremely weak. But Steve reminded all of us that market psychology mattered most. The market had shrugged off every piece of negative news since SPY traded at 70 just nine months before. The pattern to “buy the dips” had rewarded traders all during 2009. Steve counseled that if SPY held above 109.10 then this would be a signal that Dubai was just another piece of news the market would likely shrug off. It did.

As I left my office building in downtown Manhattan, I thought “Why did the market have to close early on this Black Friday? Can we fast-forward to Monday?” I just wanted to trade. I felt like Randolph and Mortimer Duke in the classic movie *Trading Places*, yelling in the middle of the trading floor “Turn those machines back on!” The only difference of course was I had just made money, not gotten a margin call for \$394 million.

Now if prop firms are essentially their own client, where is the competition? Trust me, there’s plenty of that. The market only has so much volume to go around, and every day is like a boxing match, beating all big banks, hedge funds, and automated programs to the punch.

So who are these people? Most were former Division I athletes or Ivy League math whizzes. Some sit around conference tables sipping bottled water, admiring the cufflinks on their French shirts, and stretching their toes in Gucci loafers while enjoying Central Park views from the window. (Not to be outclassed, as one can see the Statute of Liberty from some of my office’s windows). Many have more money to play with than we do, and can push us around, not

to mention more brain power, experience, and “research” information. They work at firms with names one would easily recognize. NBA superstar Kobe Bryant is known to fans simply as “Kobe” while his worthy counterpart LeBron James is simply “LeBron.” Similarly, fans of Wall Street might recognize my competitors with one name as well.

Welcome to my world. Welcome inside the highly competitive world of proprietary trading.

Unlike a big bank that is funded by large shareholders and cheap overnight lending, or a hedge fund backed by wealthy investors and institutions, a proprietary trading firm is generally funded with capital from a few partners like Steve and me. In most cases, prop firm capital is deficient to their better-known Wall Street peers. Certain firms concentrate on trading options and others, arbitrage plays. Some hold for longer time periods. Others, like ours, concentrate on trading US equities intraday. And we seek to do this better than anyone else. We employ our proprietary trading strategies with our money against the rest of the Street.

Steve and I teach our traders to locate important intraday levels and trade off of these levels. We make sure our traders focus on stocks with fresh news (Stocks In Play), and we ask them to make trading decisions based on technical analysis, reading the tape, and intraday fundamentals. If we teach them poorly, then the downside for us personally is significant. It’s our money, and our money only, after all. If we choose our traders poorly in the hiring process, then the economic cost is painful. If our firm runs out of money, then we go out of business. And the government will not be there to bail us out, though I secretly like to think we are “Too Small to Fail.”

The biggest reward of this job is the challenge to become an elite performer. I seek every day to improve, and I’ve been at this awhile. I do my best to master the psychology