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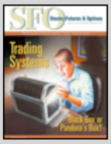

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George Soros: How He Knows What He Knows: Part 2: Combining Theory and Instinct

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Identify bodily senses and how to access the knowledge they contain.

Traders have always been told to stick to their trading methods. Success, they're told, requires discipline, which means overriding your gut. No wonder – gut feelings are notoriously unreliable. Few traders know how to separate them from emotion and turn them into reliable knowledge. Until recently, there has been no method to teach traders how to do that.

The advantages of an accurate gut are indisputable. George Soros, arguably the greatest trader of modern times, depends on his gut. "I rely a great deal on animal instincts," he wrote in his 1995 book, Soros on Soros. "When I was actively running the fund, I suffered from backache. I used the onset of acute pain as a signal that there was something wrong in my portfolio. The backache didn't tell me what was wrong – you know, lower back for short positions, left shoulder for currencies – but it did prompt me to look for something amiss when I might not have done so otherwise."

Last month, in Part I of this series, Soros' chief operating principle was introduced – the belief in fallibility and how it leads him to look for a flaw in every investment thesis.

Finding Flaws
"It pays to look for the flaws," he writes in an introduction to the 2003 edition of The Alchemy of Finance, just published by John Wiley & Sons. The fact that a trading hypothesis is flawed doesn't mean that Soros won't commit money to it – as long as he thinks some other people believe in it and that there is a larger group of people who are likely to be convinced of the validity of this thesis. "If we find them (flaws)," he writes, "we are ahead of the game…." The billion-dollar question is: How do we find them?

Soros finds the flaw by combining theory and instinct. This is puzzling because theory and instinct are usually considered mutually exclusive. This might be one of the few matters on which economists and traders agree. Economists think that gut feelings are irrational. And for most traders, instinct and method contradict each other. When traders do use their instincts, they're overriding their methodology. But in Soros' method, theory and instinct are inextricably linked. Soros himself, however, could not explain how.

This article explains how Soros combines theory and instinct to find flaws. It then shows how you, too, can learn how to think with your gut to stay ahead of the game.

The Puzzle
Last year, I wrote a paper called "How George Soros Knows What He Knows." (available at: www.marketfocusing.com). The world long has been mystified by Soros's successes. So, how did I solve the puzzle? A piece of it was my own organic theory of markets in which I link financial theory and gut feelings. Another piece was the revolutionary work of philosopher Eugene Gendlin at the University of Chicago. Gendlin showed how logical reasoning and bodily experience can work together, an achievement for which he received several awards from the American Psychological Association.

Soros himself found my explanation useful. My insights helped him with his new edition of the The Alchemy. Now he, too, speaks of "organic thinking" and can say more about the secrets of his success than ever before.

ISSUE Articles

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Reflexivity Revealed
Soros's theory of how markets operate is based on his philosophy of how thinking and reality affect each other. This contradicts assumptions of traditional economic theory.

Traditional economists view markets as "efficient." In efficient markets, prices are unbiased estimates of fundamental values. A small deviation from rationally expected fundamentals creates a self-correcting movement in another direction. But Soros disagrees. Instead, he sees that there is a feedback loop between market participants' thinking and the reality they observe. He calls this circular relationship "reflexivity."

In this theory of reflexivity, markets are always biased. Prices cannot be unbiased estimates because they actually help shape the fundamentals they are supposed to reflect.

Reflexivity introduces uncertainty into the system. As a result, Soros says, market behavior cannot be predicted by the same methods used in the natural sciences. This is why he chose the word "alchemy" for the title of his book.

In his theory of reflexivity, Soros tries to explain how trends form and what makes them reverse. It doesn't give him rules and indicators for catching those trends or reversals, but it does tell him where to look. In essence, then, it tells him to look at how the market is constructing the reality that the participants are seeing. Case in point, take the example of the collapse of Long Term Capital Management just five years ago. Nobel Prize winners Robert Merton and Myron Scholes, who owned the fund, thought they could scientifically measure their risk – and could not see how their own trades were actually shaping reality in ways that their models could not anticipate.

Profit Opportunities
Soros found his greatest profit opportunities in situations in which a market trend at first supports the "prevailing bias." The conglomerate boom of the 1960s is a classic example in which the prevailing bias emphasized earnings growth over other fundamentals. The market favored companies that showed above-average growth. Rising stock prices allowed these companies to increase their earnings by using their increasing stock value to buy other companies. This in turn strengthened the prevailing bias, which led to further stock price increases, and so it went. The trend gained momentum until corporate results could no longer sustain investors' expectations.

The flaw here was that growth was only sustainable as long as acquisitions would continue to advance at an ever-accelerating pace. The turning point was reached when Leasco Corporation failed to take over Chemical Bank. This brought the flaw to public attention.

The flaw varies from case to case, as each situation is unique. What the flaw turns out to be depends on the nature of the prevailing bias, the market involved, and much else. There are no rules for finding what the flaw is, but I can tell you where Soros finds it. It is always in the wider picture.

Organic Thinking
Market action, of course, takes place within an intricate web of interlocking economic processes, not within a vacuum. Any market hypothesis is based only on a "cut" or a piece of a multi-layered web that is continuously developing.

There's no question that market action has a visible side – certainly, the trend is there for everyone to see. Like the conglomerate boom and recent technology boom, the prevailing bias at first is confirmed. But, at the same time, the market is in interaction with a larger and more intricate economic web, causing changes in the broader picture that are not yet visible. The not-yet-visible underlying level is where Soros finds the flaw.

Soros had difficulty showing how this theory played out because once new facts in the wider picture actually emerged publicly, it appeared that they were there all along. In hindsight, it simply looked as if that the public disregarded or overlooked them. In fact, however, at the point where Soros looked for these new facts, they were still in the making. They weren't overlooked at all;

they just weren't there yet.

In reality, the evolution of the wider picture is never fully captured by any market model. There's always that gap between our particular cuts of the "real" market and the wider picture. It is in the gap between these developing changes and the prevailing bias that Soros looks for the flaw.

The array of interacting influences can't be grasped by thinking of them one by one, but the body sizes up every situation. Why? – because our bodies contain a great deal of information that is not readily available to the conscious mind. That's why Soros' back hurts when there's something wrong with his portfolio.

SIDEBAR

Six Steps to Thinking with Your Gut

The risk and expected value of every position is being affected constantly by a multiplicity of interacting influences, which we cannot keep track of one by one. Our quantitative, analytical tools rely on the assumption that things change in the future in the same ways they have changed in the past. Of course we need analysis, but relying on these tools alone can result in a tremendous mismatch between the analysis and the requirements of an actual situation. If you have an uncomfortable feeling about one or more positions, "Focusing" can help you articulate your sense of each situation.

Focusing can be applied to practically any approach to trading. Many people find it easier to learn Focusing through individual instruction than by simply reading about it. There are three stages of proficiency: the ability to find an unclear felt sense, the capacity to stay with it long enough to be able to work with it, and learning moves that can be made at that point.

What follows is simply a taste of the process – six basic steps. As you gain experience, you won't need to think of them as six separate steps of the process. They will merge as a continuum just as serving in tennis or teeing off in golf are continuums.

Step 1. Clearing a Space

Take a moment just to relax. Now, turn your attention inwards – sense how it feels inside your stomach, your chest and your throat. Now see what comes in this "inner space" when you ask, "What is between me and feeling perfectly at ease right now?" Sense yourself within your body, from the inside. Let the answer come slowly from this sensing. You will find your unease about each of the positions you want to focus on, together with some other concerns. When a concern comes, do not engage it. Stand back, say "Yes, that's there. I can feel that." Let there be a little space between you and "that." Then, wait to sense what else you feel.

Step 2. Finding the Felt Sense of Your Position

Notice how each of the different concerns you've found has its own quality. Notice how each feels a little bit different from the others. Now, select a position to focus on. Do not engage emotionally with it – stand back. Of course, there are many aspects to that position – too many to think of one-by-one. But, you can feel all of them together. Pay attention to the place where you feel these things. In there, you can get a sense of what the whole situation feels like. At first, this sense is unclear. Let yourself feel the unclear sense of the situation as a whole.

Step 3. Finding a Handle

What is the quality of this unclear felt sense? Let a word, a phrase, or an image come up from the felt sense itself. It might be a quality-word, like tight, sticky, scary, stuck, heavy, jumpy or a phrase, or an image. Stay with the quality of the felt sense until a word, a phrase or an image fits it just right. This is your handle.

Step 4. Resonating

Go back and forth between the felt sense and your handle. Check how they resonate with each other. See if there is a little body signal that lets you know there is a fit. To do this, you have to keep your attention on the felt sense while comparing it to the handle you've found. Often, the felt sense will change. If it does, change the word or picture, until they feel just right in capturing the quality of the felt sense.

Step 5. Asking

Now ask, what is it about this whole situation that makes this quality you have just named or pictured? Make sure the quality is sensed again, freshly, vividly, not just remembered from before. When you have it again, tap it, touch it, be with it, asking, "What makes the whole thing so ___ ?" Use your handle; for instance, if your handle is "tight," you ask: "What makes the whole thing so tight?" Or, ask: "What's in this __?" What you are doing now is pulling strands or aspects from the felt sense of the whole. If you get a quick answer without a shift in the felt sense, just let that answer go by. Return your attention to your body and find the felt sense again. Then ask again. Stay with the felt sense until an answer comes along with a shift, a slight "give" or release – that will feel just like the relief at remembering a name you had forgotten.

Step 6. Receiving

Give consideration to any answer that comes, even if it sounds absurd, or is a strange image, or makes you feel foolish. When something does come, your body senses change as it comes. If you went through these steps, and something has come, then your body sense changed. Now, go back to Step 2. After a few go-rounds, you will have a much richer picture of the situation. At this point, there are a number of important moves that you can make which I will explain in Part III of "George Soros: How He Knows What He Knows."

Body as Barometer
Though Soros' backache is a barometer that tells him the way in which he has "cut" market reality is leaving something crucial out, it doesn't tell him what is going wrong. He has to search for it in the wider picture. To re-cut his view, he first finds the gap between his original investment hypothesis and his bodily sense of what's actually happening. It's not just some physical manifestation that points to the need for a re-cut; it's actually a bodily sense of the situation. The key is to learn how to find and use the bodily sense of a situation.

How to Think with Your Gut
Soros' bodily knowing of the broader picture isn't mysterious. Human thinking is constantly being guided by subtle bodily tensions. For example, when we try to remember something we have forgotten, we can sense a tension – a demand by our body. We may think of many possibilities, but our body is satisfied only by the right one. Our body tries to guide us to what needs to be remembered. It lets us know – uncomfortably – that we have not yet thought explicitly about what we need to know, or it tells us – with a certain characteristic tension-release – that we've got it. When our thought is guided by this bodily felt demand, we're thinking with our gut.

Identifying these subtle bodily tensions is tapping subliminal knowledge. What we call a "felt sense" is a non-verbal aura that encompasses a plethora of accumulated knowledge and experience about a situation. Like a single note played on a violin, a felt sense can have many overtones or layers, but it is felt as a complete, unique "thing." This felt sense is not composed of bits of knowledge that add up in one's mind; rather the felt sense comes all at once.

Traders who want to know what George Soros knows can learn to identify these bodily senses, and how to access the knowledge they contain. Traders can then have the confidence to act on their bodily senses consistently. Fortunately, Eugene Gendlin has already showed what's going on inside people who can think with their gut.

Gendlin developed "Focusing," a systematic way to access this intuitive level. More than 35 years of research have shown that this is a skill that can be learned. Focusing is now taught and practiced all over the world, but only recently has it been applied to trading. (See sidebar in this article.)

Next month, in Part III, "Empathizing with the Mind of the Market," we'll explain how to intuitively feel the emotional biases affecting the market without being carried away by fear and greed.

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