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George Soros: How He Knows What He Knows: Part 1: The Belief in Fallibility (First in a Four-Part Exclusive Series)

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There are few who have not been dazzled by George Soros' ability to trade the markets. The guy is a legend. This series, which appears this month and three consecutive months hence, brings to light how he knows what he knows. This month, we touch on the billionaire speculator's theories and bodily signals, and how they work in parallel.

To many who worship at the alter of the icons of Wall Street, billionaire George Soros, now a philanthropist of note, is considered the 20th century's greatest trader. His lifetime record as a speculator, who made massive wagers on market direction at numerous opportune times, is unparalleled – even if he inevitably did make some expensive mistakes along the way. Anyone who had invested $1,000 in his Quantum Fund when it jumped out of the box in 1969 would have realized a cumulative 30-plus-percent annual return – or about $4 million – by the turn of the new century. How did he achieve his incredible performance? He himself attributes his success to a combination of theory and instinct.

In Soros' theory of how markets operate, the perceptions of market participants help create their own reality. This leads to self-reinforcing processes that are eventually self-defeating.

According to Soros, his theory informs his decisions, and his body gives him the signals. The making of a self-reinforcing trend brings water to his mouth. The need for a portfolio shift makes his back hurt. His body "knows" he needs to take action, or to take careful note of a situation before his intellect can grasp it.

The way in which Soros' theory and his body work together remains a mystery for most people. Not having understood his theory, they wrongly take the now famous quote by his son, Robert, as evidence that Soros trades using nothing more than instinct: "My father will sit down and give you theories to explain why he does this or that. But I remember seeing it as a kid and thinking…at least half of this is bull_ _ _ _. I mean, you know the reason he changes his position on the market or whatever is because his back starts killing him. It has nothing to do with reason. He literally goes into a spasm, and it's this early warning sign." [Cited in Michael Kaufman's biography Soros: The Life and Times of a Messianic Billionaire (2002), p. 140]

Zeroing In

Relating economics and gut feeling is, admittedly, no easy task. Most economists' ideal of the market is an information processor, a machine. They appear to believe that "rational economic man" is a computer that obviously does not have instincts.

Computers follow rules rigidly. But, rigidly following rules can only be rational in a world devoid of uncertainty, where things change in the future in the same ways that they changed in the past. Most economic models assume uncertainty away. They simply leave it out of the picture because, unlike probabilistic risk, uncertainty can't be quantified. But for Soros, uncertainty is the nature of the game. Dealing with uncertainty is what trading is all about.

In my doctoral work in financial economics I found that markets do not work like machines, but rather like living beings, and that rationality under uncertainty requires more than logic alone. Thus, I found myself in a unique position to be able to explain how Soros combines

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analysis and instinct.

Realizing that logic alone cannot be the basis for successful speculation led me to study bodily knowing in my post-doctoral research. There's a whole side to our embodied, experiential knowledge that computers don't have and that the "rational economic man" in models most economists construct doesn't have either. Our bodies "know" the situations we meet in life and how they can unfold. I found that physical experience has much more organized information about the world than the usual understanding of the body assumes.

Using the work of Eugene Gendlin, Ph.D., a world-renowned philosopher and psychologist, I've developed a methodology, called MarketFocusing, to combine gut feeling and logic to improve decision-making in markets. For several years, I have been helping traders improve their performance by accessing their bodily knowledge and increasing its reliability. In other words, I teach traders how to develop their biological software.

Putting my expertise in relating economics and gut feeling to good use, I wrote a paper called "How George Soros Knows What He Knows." It explains how Soros's theory and his bodily feelings work in parallel.

I sent my paper to Soros. He read it, found it very interesting and invited me to visit him. When I met him earlier this year, I was very pleased to learn that he is going to incorporate some of my insights in his introduction to a new edition of The Alchemy of Finance that should be out shortly.

The original paper is long and densely written. It incorporates economics, psychology and epistemology, a branch of philosophy that studies the grounds of knowledge. But for SFO magazine I'm simplifying, condensing and splitting my explanation into four parts (the original paper, as well as other articles, can be found on my website: www.marketfocusing.com).

This article is Part I. It explains Soros' operating principle, which he calls "The Belief in Fallibility." It sets the stage for understanding what Soros' edge is. It also offers an exercise that traders can use to befriend fallibility and improve their trading. The other three articles will also include exercises that teach traders how to access their bodily knowledge and make it reliable.

Part II is "Combining Theory and Instinct." It will show how uncertainty requires that traders use their bodily knowledge and relate it to their conscious analysis.

Part III, "Empathizing with the Mind of the Market," explains how intuitive thinking can be used by traders to read the market's biases as well as their own.

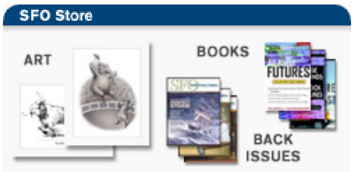
Part IV, "Using Reflexivity in Trading" is an explanation of Soros' Theory of Reflexivity.

Fallibility
The single-most important belief that traders hold dear is that the market is always right. But George Soros takes the opposite position. "I assume that markets are always wrong."

This seemingly surprising assumption is one expression of his operating principle. The "Belief in Fallibility" is his general view of the world and one that he then applies to markets.

For Soros, it is impossible to form a mental picture of the world in which we live without distortion. All mental constructs – models, theories, hypotheses and systems – are potentially and often actually flawed. Even when they contain significant elements of truth, they are distortions of reality.

Market reality is very complex. It is an intricate web of interlocking, interdependent processes or systems which is so complex that it cannot be captured by any single market model. Any market hypothesis is based on a "cut" of reality.
No single "cut" of reality is unique, nor is it permanent. This is why all hypotheses are flawed for two reasons. First, one's mental map does not describe the real territory. Second, reality doesn't stay put, so that a useful "cut" today doesn't necessarily remain useful tomorrow. The territory itself keeps changing.



When we open a trading position, we are testing a hypothesis. It can be as simple as "prices are going up/down," or as complex as relationships between macro-global economic forces. But the market itself also can be viewed as constantly adopting and testing hypotheses. When one hypothesis fails, the market takes on another.

The market's hypotheses are based on "cuts" that make up the current collective view of reality. Markets are always wrong in the sense that they are always biased.

Soros finds profit opportunities in situations where the prevailing bias is having unintended consequences which cannot be readily seen from within the conventional "cut" of reality. At the explicit level, the market's hypothesis seems at first to be confirmed, and this reinforces the trend. But at an implicit, underlying level, the market's action is creating a very different effect that eventually makes the trend unsustainable.

The Belief in Fallibility anchors another of Soros' distinguishing characteristics. Not only does he assume that the markets are always wrong, but that his own hypotheses are also always flawed. Most people are invested in being right and don't like to admit that they are wrong. Soros thinks the other way around. In his book Open Society, he wrote: "I derived actual pleasure from discovering a mistake."

In Soros on Soros, he explained further, "To others, being wrong is a source of shame. To me, recognizing my mistakes is a source of pride. Once we realize that imperfect understanding is the human condition, there's no shame in being wrong, only in failing to correct our mistakes."

The Belief in Fallibility is a psychologically sound principle. It allows Soros to avoid holding himself to standards that no human can possibly meet. This protects him from crises of confidence. For most people, the possibility of being wrong is threatening. It gives rise to anxiety. Soros, on the other hand, is anxious as long as he hasn't found a flaw in his investment hypothesis. He actively looks for it – and his back hurts as long as he hasn't found it. Once he knows the flaw, he's at ease. He's got his edge.

The discovery of a flaw, an error in his thinking, allows him to take whatever profits he had made from his flawed insight – or cut losses. The difference between Soros and most other traders is that he accepts fallibility, so he starts out by assuming his hypothesis is wrong, rather than right like almost everyone else.

While markets are always wrong, it doesn't follow that one should trade against a prevailing trend. Finding a flaw in an investment or trading thesis doesn't make Soros discard it. Rather, it helps him play it with greater confidence because he knows what is wrong with it while the market doesn't. Finding a flaw puts him ahead of the curve.

For Soros, the Belief in Fallibility means a commitment to open-mindedness, in life as well as in trading. Reality is multi-leveled, not a single territory, but a multiplicity of ever-changing territories. We had better keep our eyes open and avoid rigid belief systems and "either-or thinking" that could lead us to overlook crucial flaws. In markets, as well as in life, this can be deadly.

How can any trader be comfortable with being wrong? The first step is to befriend your fallibility. The experiential exercise in the sidebar of this article will help you do that.

SIDEBAR
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The body is the door into seeing where you have to re-examine a flaw in your trade. Once you can sense the body in a certain way, you can discover what you had not seen previously. The following set of exercises can help you begin to do this. It teaches you how to use the body to befriend fallibility.

Here's how to do the exercises. Don't rush through them; otherwise you won't learn anything. It might help you to write down what you find at each step. You might find that, at first, what you write does not exactly match what you are experiencing. That's a good sign. It means that you are touching something which your body knows that your head does not know yet.

Befriending Fallibility

1. Ask yourself, "What am I like when I am invested in being right – when I have to be right? What do I feel? What do I tend to do?" For example, "do I start to shout? Do I grind my teeth?"

2. Now think of two different situations: A time when you added to losing positions because you were invested in being right, perhaps telling yourself, "The market has got to be wrong!" Then, think of a time when you added to a losing position because you felt a "green light," you were confident in your initial hypothesis, and the trade turned out to be a good one.

3. Now, leave these examples to the side for a moment and close your eyes. Spend a moment sensing your throat, your chest and your belly from the inside. Ask yourself: "What do I feel like in my body right now?" You might feel, for example, something constricted in your "inner space." Or, you might feel something like an "inner weather" – perhaps just calmness or openness.

4. As you sense yourself from within, recall the good trade in Step 2. Can you notice some changes? What's your "inner space" like now? What you are looking for is the bodily side of your state of mind. You should be able to feel in your body what it was like.

5. Now recall the bad trade in Step 2. Ask yourself what wanting to be right feels like in your body. Ask the question and just wait a little bit, sensing yourself from within. Feel the difference in your body? What's it like? When we are invested in being right, our insistence has a certain affective tone, an emotional quality. Recall the situation until you can feel this quality in your body. Staying in touch with it, ask yourself what this quality is like.

6. Look for a word to describe this quality – this felt sense. It might be a quality word – like "jumpy" or "blue," or an emotion, or a phrase. Compare the word you found with the bodily sensation itself. If the description is a good one, you'll sense a slight release, like suddenly remembering a name you had forgotten and were trying to recall. If you can't get a good word for this felt sense, try to describe it using an image or a metaphor.

Now that you're better acquainted with the part of you that wants to be right – What do you do when it shows up? There is no use in beating yourself up for not corresponding to the image of what you should be. You can't expel that part of you that wants to be right. If you send it into exile, it will return through the back door and unconsciously guide your actions. The solution, which might sound paradoxical, is to befriend IT.

7. Say "hello" to the felt sense of wanting to be right. "Hi, I know you're there" as if IT were another person. Instead of treating IT as an enemy you want to get rid of, welcome IT as if IT were an old friend.

8. Begin observing the felt sense of wanting to be right with interested curiosity. Ask, "What is IT like right now?" The part of you that wants to be right might have felt at first irritated, impatient, agitated, somber, angry, maybe even violent. Or, perhaps you didn't feel a clear-cut emotion, only a vague feeling halfway between an emotion and a physical sensation, such as unease, impatience, heaviness or constriction.

9. Keep observing IT more and more carefully. Can you sense ITS defensiveness? Can you sense ITS underlying fear? What is this fear like? Where do you feel it? Can you sense it in your throat, in your chest, in your belly? What is the quality of this particular fear? Is it, for instance, a tight fear, or a red fear? What kind of fear is it?

Your head might jump with an answer, but what you're looking for is feeling-response, the release that comes when you find the right description for a felt sense. You want to feel this response in your body. If you do this correctly, you will experience how the fear is much less threatening or overwhelming than one would initially assume. You might then experience a kind of groundlessness and, yet, feel very present and comfortable with the uncertain, changing nature of things. This will let you get in synch with the market.

If you didn't get there, don't be discouraged. Finding the bodily felt sense and working with it so that you can feel a shift takes practice. We'll give you more specific instructions in the rest of our Soros series. You can always come back to this exercise.

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Listen to the Body
The next step is to become able to listen to your bodily signals to access the knowledge they contain. Soros' backache is a barometer that guides him in looking for his flaw. This might sound mysterious but, in fact, human thinking is constantly guided by subtle bodily tensions. Traders need to learn how to isolate and identify these bodily tensions and relate them to the analysis of the market problem at hand.

Certainly, Soros has learned how to combine theory and instinct to make money. This process can be learned by almost anyone. I use exercises that teach any willing person to do this. We'll explain more about how you can let your gut feelings work together with your analysis in informing your trading decisions next month in Part II of this series, "Combining Theory and Instinct."