The Zurich Axioms

By Barry Ritholtz - February 25th, 2011, 3:00PM

Max Gunther set forth basic trading principles called The Zurich Axioms:

On Risk:
- Worry is not a sickness but a sign of health – if you are not worried, you are not risking enough.
- Always play for meaningful stakes – if an amount is so small that its loss won't make any significant difference, then it isn't likely to bring any significant gains either.
- Resist the allure of diversification.

On Greed:
- Always take your profit too soon.
- Decide in advance what gain you want from a venture, and when you get it, get out.

On Hope:
- When the ship starts sinking, don't pray. Jump.
- Accept small losses cheerfully as a fact of life. Expect to experience several while awaiting a large gain.

On Forecasts:
- Human behaviour cannot be predicted. Distrust anyone who claims to know the future, however dimly.

On Patterns:
- Chaos is not dangerous until it starts to look orderly.
- Beware the historian's trap – it is based on the age-old but entirely unwarranted belief that the orderly repetition of history allows for accurate forecasting in certain situations.
- Beware the chartist's illusion – it is characteristic of human minds to perceive links of cause and effect where none exist.
- Beware the gambler's fallacy – there's no such thing as "Today's my lucky day" or "I'm hot tonight".

On Mobility:
- Avoid putting down roots. They impede motion.
- Do not become trapped in a souring venture because of sentiments like loyalty and nostalgia.
- Never hesitate to abandon a venture if something more attractive comes into view.

On Intuition:
- A hunch can be trusted if it can be explained.
- Never confuse a hunch with a hope.

On the Occult:
- If astrology worked, all astrologers would be rich.
- A superstition need not be exorcised. It can be enjoyed, provided it is kept in its place.

On Optimism & Pessimism:
- Optimism means expecting the best, but confidence mean knowing how you will handle the worst. Never make a move if you are merely optimistic.

On Consensus:
- Disregard the majority opinion. It is probably wrong.

- Never follow speculative fads. Often, the best time to buy something is when nobody else wants it.

On Stubbornness:
- If it doesn't pay off the first time, forget it.
- Never try to save a bad investment by "averaging down".

On Planning:
- Long-range plans engender the dangerous belief that the future is under control. It is important never to take your own long-range plans or other people's seriously. In essence these axioms point to the benefit of having an investment strategy and sticking to it, regardless of what other investors say or do. If you don't have an investment strategy, you could do worse than adopt these principles. However, don't be afraid to add or subtract ones according to what works for you.

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The Zurich Axioms

A friend game me a fantastic book "The Zurich Axioms" by Max Gunther which I think any investor should read. Here is what I learnt.

"The First Major Axiom: on Risk

Worry is not a sickness but a sign of health. If you are not worried, you are not risking enough.

Minor Axiom I.

Always play for meaningful stakes.

Minor Axiom II.

Resist the allure of diversification.

Strategy

Now let's review the First Axiom quickly. Specifically, what does the axiom advise you to do with your money?

It says put your money at risk. Don't be afraid of getting hurt a little. The degree of risk you will usually be dealing with is not hair-raisingly high. By being willing to face it, you give yourself the only realistic chance you have of rising above the great unrich.

The price you pay for this glorious chance is a state of worry. But this worry, the First Axiom insists, is not the sickness modern psychology believes it to be. It is the hot and tart sauce of life. Once you get used to it, you enjoy it.

The Second Major Axiom: on Greed

Always take your profit too soon.

Minor Axiom III.

Decide in advance what gain you want from a venture, and when you get it, get out.

Strategy

Now let's see just what the Second Axiom advises you to do.

It says, "Sell too soon." Don't wait for booms to reach their peaks. Don't hope for winning streaks to go on and on. Don't stretch your luck. Expect winning streaks to be short. When you reach a previously decided-upon ending position, cash out and walk away. Do this even when everything looks rosy, even when you're optimistic, even when everybody around you is saying the boom will keep roaring along. The only reason for not doing it would be that some new situation has arisen, and this situation makes you all but certain that you can go on winning for a while.

Expect in such unusual circumstances, get in the habit of selling too soon. And when you've sold, don't torment yourself if the winning set continues without you. In all likelihood it won't continue long. If it does, console yourself by thinking of all the times when selling too soon preserved gains you would otherwise have lost.

The Third Major Axiom: on Hope

When the ship starts to sink, don't pray. Jump.
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Minor Axiom IV.
Accept small losses cheerfully as a fact of life. Expect to experience several while awaiting a large gain.
Strategy
The Third Axiom tells you not to wait around when trouble shows itself. It tells you to get away promptly.
Don't hope, don't pray. Hope and prayer are nice, no doubt, but they are not useful as tools of a speculative operation.
Nobody pretends it is easy to carry out the teaching of this hard, unsentimental Axiom. We've looked at three obstacles to its implementation: fear of regret, unwillingness to abandon part of an investment, and difficulty of admitting a mistake. One or more of these problems may afflict you, perhaps severely. Somehow or other, you have to overcome them.
The Axioms are about speculation, not psychological self-help, and therefore they have no advice to offer on how you overcome these obstacles. That is an internal and individual process; the how is probably different for each of us. The Third Axiom says only that learning to take losses is an essential speculative technique. The fact that most men and women fail to learn the technique is one of the key reasons why most are not good speculators or gamblers.
The Fourth Major Axiom: on Forecasts
Human behavior cannot be predicted. Distrust anyone who claims to know the future, however dimly.
Strategy
The Fourth Axiom tells you not to build your speculative program on a basis of forecasts, because it won't work. Disregard all prognostications. In the world of money, which is a world shaped by human behavior, nobody has the foggiest notion of what will happen in the future. Mark that word. Nobody.
Of course, we all wonder what will happen, and we all worry about it. But to seek escape from that worry by leaning on predictions is a formula for poverty. The successful speculator bases no moves on what supposedly will happen but reacts instead to what does happen.
Design your speculative program on the basis of quick reactions to events that you can actually see developing in the present. Naturally, in selecting an investment and committing money to it, you harbor the hope that its future will be bright. The hope is presumably based on careful study and hard thinking. Your act of committing dollars to the venture is itself a prediction of sorts. You are saying, "I have reason to hope this will succeed." But don't let that harden into an oracular pronouncement: "It is bound to succeed because interest rates will come down." Never, never lose sight of the possibility that you have made a bad bet.
If the speculation does succeed and you find yourself climbing toward a planned ending position, fine, stay with it. If it turns sour despite what all the prophets have promised, remember the Third Axiom. Get out.
The Fifth Major Axiom: on Patterns
Minor Axiom V.
Beware the Historian's Trap.
Minor Axiom VI.
Beware the Chartist's illusion.
Minor Axiom VII.
Beware the Correlation and Causality Delusions.
Minor Axiom VIII.
Beware the Gambler's Fallacy.
Strategy
Now let's see specifically how the Fifth Axiom advises you to handle your money.
The Axiom warns you not to see order where order does not exist. This doesn't mean you should despair of ever finding an advantageous bet or a promising investment. On the contrary, you should

study the speculative medium in which you are interested -–the poker table, the art world, what-ever it is – and when you see something that looks good, take your best shot.

But don't be hypnotized by an illusion of order. Your studying may have improved the odds in your favor, but you still cannot ignore the overwhelmingly large role of chance in the venture. It is unlikely that your studying has created a sure thing for you, or even a nearly sure thing. You are still dealing with chaos. As long as you remain keenly alert to that fact, you can keep yourself from getting hurt.

Your internal monologue should go like this: "Okay, I've done my homework as well as I know how. I think this bet can pay off for me. But since I cannot see or control all the random events that will affect what happens to my money, I know that the chance of my being wrong is large. Therefore I will stay light on my feet, ready to jump this way or that when whatever is going to happen happens."

And that is the lesson of the Fifth Axiom. You are getting to be a smarter speculator all the time.

The Sixth Major Axiom: on Mobility

Avoid putting down roots. They impede motion.

Minor Axiom IX.

Do not become trapped in a souring venture because of sentiments like loyalty and nostalgia.