Trader Risk Management Lore: Taleb's Major Rules of Thumb

Rule No. 1- Do not venture in markets and products you do not understand. You will be a sitting duck.

Rule No. 2- The large hit you will take next will not resemble the one you took last. Do not listen to the consensus as to where the risks are (that is, risks shown by VAR). What will hurt you is what you expect the least.

Rule No. 3- Believe half of what you read, none of what you hear. Never study a theory before doing your own observation and thinking. Read every piece of theoretical research you can-but stay a trader. An unguarded study of lower quantitative methods will rob you of your insight.

Rule No. 4- Beware of the nonmarket-making traders who make a steady income-they tend to blow up. Traders with frequent losses might hurt you, but they are not likely to blow you up. Long volatility traders lose money most days of the week. (Learned name: the small sample properties of the Sharpe ratio).

Rule No. 5- The markets will follow the path to hurt the highest number of hedgers. The best hedges are those you alone put on.

Rule No. 6- Never let a day go by without studying the changes in the prices of all available trading instruments. You will build an instinctive inference that is more powerful than conventional statistics.

Rule No. 7- The greatest inferential mistake: "This event never happens in my market." Most of what never happened before in one market has happened in another. The fact that someone never died before does not make him immortal. (Learned name: Hume's problem of induction).

Rule No. 8- Never cross a river because it is on average 4 feet deep.

Rule No. 9- Read every book by traders to study where they lost money. You will learn nothing relevant from their profits (the markets adjust). You will learn from their losses.