MASTER THE MARKETS

Taking a Professional Approach to Trading & Investing by Using Volume Spread Analysis

Tom Williams

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All charts in this book have been provided courtesy of either VSA™ or TradeGuider™ computer software systems.

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This publication is designed to provide accurate and authoritative information with regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional person should be sought.

The contents of this book refer to, and explain, the *basic introductory principles* of the proprietary VSA™ (Volume Spread Analysis™) methodology, which is built into the TradeGuider™ software (formerly the VSA™ software).

The indicators displayed on the charts are not buy or sell signals, but show either strength or weakness entering the market. The signals are based on the laws of supply and demand, and show how these forces can be decoded and represented on a chart.

Acknowledgement

This book is the product of a great deal of research, reflection, and a realisation that the financial markets cannot be encapsulated by a single, unified mathematical formula, or collection of mathematical formulae.

My personal development would not have been the same without the help, support, and pooling of knowledge with others over the years. Prominent among these people is Tom Williams, a veteran trader who is now 77 years old. He is a fascinating man, with an enviable knowledge of market mechanics and was the first trader to open my mind to the real workings of the financial world. Tom has an intimate understanding of what really goes on behind the scenes, in professional circles, owing to his 12-plus years experience in Beverley Hills, California, working with a trading syndicate (off the floor stock traders).

Williams is a brilliant analyst, with a very different thinking from all other public personalities in the trading world. Some would say that Tom is a genius, and due to his extensive knowledge of the markets, his innovative theories and faultless comprehension, I am inclined to agree with this opinion.

The VSA trading software was created in the early 1990's, as a result of his aspiration to pass on his knowledge to help other traders. Through his seminars in the UK and his book, "The Undeclared Secrets That Drive the Stock Market", Tom realised his ambition to help the next generation of traders.

Williams has been instrumental in my understanding of the markets, and has spent many long hours, patiently explaining how the markets work, and how they are ultimately designed to cause the uninitiated to lose money. I owe a large debt of gratitude to him, for 'lifting the veil' on the tricks and tactics practised by the market-makers and other professional players, who use a multitude of methods to profit from the unwary.

If you are interested in the markets, you will find the contents of this book immensely interesting. Unlike many other books, you will find the ideas presented herein difficult to dispute – they make sense and are based on hard facts, rather than abstract theories!

I hope that after reading this book that you feel just as excited as I was about the prospects of trading in a more professional manner. There is a significant amount of information in this book that will help you take your trading and investing to the next level. My advice is to take your time whilst reading this book and concentrate on the various definitive moves to look out for – try to imagine what is really happening behind the scenes. It takes a bit of time to take onboard these new ideas, but I can promise that disciplined study and observation will reap rewards.

If you have always felt that there is something missing in your understanding of how things fit together, this book has been written for you. I sincerely hope that you enjoy being initiated to a new level of awareness!

R Didlock

ROY DIDLOCK
President, TradeGuider Systems

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Preamble

The Volume Spread Analysis (VSA) Methodology and TradeGuider

Our proprietary Volume Spread Analysis™ technology is used to generate the indicators in TradeGuider™. All of the charts in this book were taken from the TradeGuider or VSA software (the forerunner to TradeGuider). In order to maintain the continuity, meaning, and relevance of the original text, we have chosen to keep the original (VSA) illustrations in some parts of the book, as reference is made to various points on the charts for teaching purposes.

This book is your foundation course in the Volume Spread Analysis™ (VSA™) methodology, which takes a multi-dimensional approach to analysing the market, and looks at the relationship between price, spread, and volume.

For the correct analysis of volume, one needs to realise that the recorded volume information contains only half of the meaning required to arrive at a correct analysis. The other half of the meaning is found in the price spread. Volume always indicates the amount of *activity* going on, the corresponding price spread shows the price *movement* on that volume. This book explains how the markets work, and, more importantly, will help you to recognise indications as they occur at the live edge of a trading market – indications that a pit trader, market-maker, specialist, or a top professional trader would see and recognise.

Volume Spread Analysis seeks to establish the *cause* of price movements, and from the cause, predict the future direction of prices. The 'cause' is quite simply the imbalance between *Supply and Demand* in the market, which is created by the activity of professional operators.

The *effect* is either a bullish or bearish move according to the prevailing market conditions. We will also be looking at the subject from the other side of the trade.

It is the close study of the reactions of the Specialists and Market-Makers which will enlighten you to future market behaviour. Much of what we shall be discussing is also concerned with the psychology of trading, which you need to fully understand, because the professional operator does and will take full advantage of it wherever possible. Professionals operating in the markets are very much aware of the emotions that drive YOU (and the *herd*) in your trading. We will be looking at how these emotions are triggered to benefit professional traders and, hence, price movements.

Introduction

The Largest Business in the World

Every working day, *billions* of dollars exchange hands in the world's stock markets, financial futures and currency markets. Trading these markets is by far the largest business on the planet. And yet, if you were to ask the average businessman or woman why we have bull markets or why we have bear markets, you will receive many opinions.

The average person has absolutely no idea what drives the financial markets. Even more surprising is the fact that the average trader doesn't understand what drives the markets either!   Many traders are quite happy to blindly follow mechanical systems, based on mathematical formulas that have been back-tested over 25 years of data to 'prove' the system's predictive capacity. However, most of these traders have absolutely no idea whatsoever as to the underlying cause of the move. These are intelligent people. Many of them will have been trading the financial markets, in one way or another, for many years. A large number of these traders will have invested substantial amounts of capital in the stock market.

So, despite financial trading being the largest business in the world, it is also the least understood business in the world. Sudden moves are a mystery, arriving when least expected and appearing to have little logic attached to them. Frequently, the market does the exact opposite of a trader's intuitive judgement. Even those who make their living from trading, particularly the brokers and the pundits, whom you would expect to have a detailed knowledge of the causes and effects in their chosen field, very often know little about how the markets really work.

It is said that up to 90% of traders are on the losing side of the stock market. So perhaps many of these traders already have the perfect system to become very successful – all they need to do is trade in the opposite direction to what their gut feeling tells them!   More sensibly, this book will be able to help you trade intuitively, but in a way a professional does.

Below is a brief series of questions – as an experiment, see if you can answer any of them:

- Why do we have bull markets?
- Why do we have bear markets?
- Why do markets sometimes trend strongly?
- Why do the markets sometimes run sideways?
- How can I profit from all of these movements?

If you can answer these questions with confidence you do not need to read this book. If on the other hand you cannot, do not worry because you are not alone, and you will have the answers by the time you have reached the end of the book.

It is interesting to note that the army puts a great of effort into training their soldiers. This training is not only designed to keep the men fit and to maintain discipline, but is designed around drills and procedures learned by rote. Drills are practised repeatedly until the correct response becomes automatic. In times of extreme stress which is encountered in the haze of battle (trading in your case), the soldier is equipped to quickly execute a plan of evasive action, suppressing fear and excitement, ensuring a correct response to minimise or eradicate whatever threat the soldier is exposed to. Cultivating this automatic and emotionless response to danger should be your mission too.

Good traders develop a disciplined trading system for themselves. It can be very sophisticated or very simple, as long as you think it will give you the edge you will certainly need. A system that is strictly followed avoids the need for emotion, because like the trained soldier, you have already done all the 'thinking' before the problems arrive. This should then force you to act correctly while under trading duress. Of course, this is easy to say, *but very difficult to put into practice*.

Remember, trading is like any other profession, insofar as the accumulation of knowledge is concerned, but this is where the similarity stops. Trading is a *rite of passage* – the road will be long, the terrain will be tough, you will suffer pain. Trading is not glamorous! At this juncture, you do not need to worry about any of these things. This book will act as your ‘brief’, ‘intelligence report’, and ‘operations manual’. Read through the whole of this book – it will serve you well. You may not agree with all of the content, but that is not important – if you have absorbed the principles, the purpose of this book will have been fulfilled.

As you gain more experience, you will see that the markets do in fact move to the dictates of supply and demand (and little else). Imbalances of supply and demand can be detected and read in your charts, giving you a significant advantage over your peers. If you own the TradeGuider software, you will see that it does an excellent job of detecting these key imbalances for you, taking the hard work out of reading the markets, and enabling you to fully concentrate on your trading.

Section 1

Market Basics

Random Walks & Other Misconceptions

To most people, the sudden moves seen in the stock market are a mystery. Movements seem to be heavily influenced by news and appear when least expected; the market usually does the exact opposite to what it looks like it should be doing, or what your gut feeling tells you it ought to be doing. Sudden moves take place that appear to have little to do with logic: We sometimes observe bear markets in times of financial success, and strong bull markets in the depths of recession.

It seems a place for gamblers, or for those people that work in the City, or on Wall St – who must surely know exactly what is going on! This is a fallacy. If you can take a little time to understand the contents of this book, the heavy burden of confusion will be removed from you forever. The stock market is not difficult to follow if you can read charts correctly, as a top professional would. You'll understand exactly how to recognise the definitive moments of market action, and the sorts of pre-emptive signs to look out for, just before a market rises or falls. You'll know how a bull market is created, and also the cause of a bear market. Most of all you will begin to understand how to make money from your new-found knowledge.

The markets are certainly complex – so complex, in fact, that it has been seriously suggested that they move at random. Certainly, there is a suggestion of randomness in the appearance of the charts, irrespective of whether you are looking at stocks or commodities. I suspect however, that those who describe market activity as 'random' are simply using the term loosely, and what they really mean is that movements are chaotic. Chaos is not quite the same thing as randomness. In a chaotic system there may be hundreds, or even thousands of variables, each having a bearing on the other. Chaotic systems may appear unpredictable, but as computing technology advances, we will start to find order, where before we saw randomness. Without doubt, it is possible to predict the movements of the financial markets, and as technology advances, we will become better at it. There is an enormous gulf between unpredictability and randomness.

Unless you have some idea of the various causes and effects in the markets, you will undoubtedly, and frequently, be frustrated in your trading. Why did your favourite technical tool, which worked for months, not work "this time" when it really counted? How come your very accurate and detailed fundamental analysis of the performance of XYZ Industries failed to predict the big slide in price two days after you bought 2,000 shares in it?

The stock market appears confusing and complicated, but it is most definitely based on logic. Like any other free market place, prices in the financial markets are controlled by *supply and demand* – this is no great secret. However, the laws of supply and demand, as observed in the markets, do not behave as one would expect. To be an effective trader, there is a great need to understand how supply and demand can be interpreted under different market conditions, and how you can take advantage of this knowledge. This book will help you to do this – read on…

What is the Market?

Every stock market is comprised of individual company shares that are listed on an exchange. These markets are composed of hundreds or thousands of these instruments, traded daily on a vast scale, and in all but the most thinly traded markets, millions of shares will change hands every day. Many thousands of individual deals will be done between buyers and sellers. All this activity has to be monitored in some way. Some way also has to be found to try and gauge the overall performance of a market. This has led to the introduction of market indices, like the Dow Jones Industrial Average (DJIA) and the Financial Times Stock Exchange 100 Share Index (FTSE100). In some cases the Index represents the performance of the entire market, but in most cases the Index is made up from the "high rollers" in the market where trading activity is usually greatest.

In the case of the FTSE100, you are looking at one hundred of the strongest leading companies' shares, weighted by company size, then periodically averaged out to create an Index. These shares represent an equity holding in the companies concerned and they are worth something in their own right. They therefore have an intrinsic value as part-ownership of a company which is trading.

The first secret to learn in trading successfully (as opposed to investing), is to forget about the intrinsic value of a stock, or any other instrument. What you need to be concerned with is its *perceived value* - its value to professional traders, not the value it represents as an interest in a company. The intrinsic value is only a component of perceived value. This is a contradiction that undoubtedly mystifies the directors of strong companies with a weak stock! From now on, remember that it is the *perceived value* which is reflected in the price of a stock, and not, as you might expect, its intrinsic value. We shall return to this later, when looking at the subject of stock selection.

Have you ever wondered why the FTSE100 Index (or any other index) has generally shown a more or less continuous rise since it was first instigated? There are many contributory factors: inflation, constant expansion of the larger corporations and long-term investment by large players; but the most important single cause is the simplest and most often overlooked – the creators of the Index want it to show the strongest possible performance and the greatest growth. To this end, every so often they will weed out the poor performers and replace them with up-and-coming strong performers.

The Market Professionals

In any business where there is money involved and profits to make, there are professionals. We see professional diamond merchants, professional antique and fine art dealers, professional car dealers and professional wine merchants, among many others. All these people have one thing in mind; they need to make a profit from a price difference to stay in business.

The financial markets are no different and professional traders are also very active in the stock and commodity markets – these people are no less professional than their counterparts in other areas. Doctors are collectively known as professionals, but in practice they split themselves up into specialist groups, focusing on a particular field of medicine – professional market traders do the same and also specialise in various areas.

It's important to realise at this stage, that when we refer to the definition of a professional, we are not talking about the 'professionals' who run your investment fund or pension. At the time of writing this section (June 2003), the vast majority of investment funds have been making huge losses for the last 4 years! Furthermore, some of these investment fund companies (including insurance firms) have even closed down, owing to their inability to invest wisely in the markets. People nearing retirement are extremely worried, as the value of their pension plummets further into the doldrums – some pension companies have even been reported to be teetering on the brink of financial crisis. In the UK, the vast majority (if not all) of the endowment funds are in trouble, even failing to make meagre returns of 6%, which means that most homeowners are now at serious risk of not being able to raise funds to pay for their homes.

The 'professionals' in the previous examples do not live by their trading talents, instead they receive a salary from the respective investment or pension fund company – which is just as well, since these people would otherwise be homeless! I make no apology for these scathing comments, since millions of people have been adversely affected on a global scale, and billions of dollars have been lost to the witless idiots who have been given the responsibility of investing your hard-earned money. The truth of the matter is that most fund managers find it difficult to make profits unless there is a raging bull market.

So what do I mean by a professional trader? Well, one example is the private syndicate traders that work in co-ordinated groups to *accumulate* (buy), or distribute (sell), huge blocks of stock to make similarly huge profits. You can be absolutely certain that these traders have made more money from distributing stock in the last four years, than they did during the bull market in the 1980s. Why? Because we have just witnessed one of the best moneymaking periods in your lifetime – the largest fall in stock prices for decades…

A Special Word About Market-Makers

It is important to understand that the market-makers do not control the market. They are responding to market conditions and taking advantage of opportunities presented to them. Where there is a window of opportunity provided by market conditions – panic selling or thin trading – they may see the potential to increase profits through price manipulation, but they can only do so if the market allows them to. You must not therefore assume that market-makers control the markets. No individual trader or organisation can control any but the most thinly traded of markets for any substantial period of time.

Market-makers are fully aware of the activities of trading syndicates and other professional operators that place substantial orders. It therefore makes sense that they will take whatever opportunity is available to better their own accounts accordingly.

Volume – The Key to the Truth

Volume is the major indicator for the professional trader.

You have to ask yourself why the members of the self-regulated Exchanges around the world like to keep true volume information away from you as far as possible. The reason is because they know how important it is in analysing a market!

The significance and importance of volume appears little understood by most non-professional traders. Perhaps this is because there is very little information and limited teaching available on this vital part of technical analysis. To use a chart without volume data is similar to buying an automobile without a gasoline tank.

Where volume is dealt with in other forms of technical analysis, it is often viewed in isolation, or averaged in some way across an extended timeframe. Analysing volume, or price for that matter, is something that cannot be broken down into simple mathematical formulae. This is one of the reasons why there are so many technical indicators – some formulas work best for cyclic markets, some formulas are better for volatile situations, whilst others are better when prices are trending.

Some technical indicators attempt to combine volume and price movements together. This is a better way, but rest assured that this approach has its limitations too, because at times the market will go up on high volume, but can do exactly the same thing on low volume. Prices can suddenly go sideways, or even fall off, on exactly the same volume! So, there are obviously other factors at work.

Price and volume are intimately linked, and the interrelationship is a complex one, which is the reason TradeGuider was developed in the first place. The system is capable of analysing the markets in real-time (or at the end of the day), and displaying any one of 400 indicators on the screen to show imbalances of supply and demand.

Urban Myths You Should Ignore

There are frequent quotes on supply and demand seen in magazines and newspapers, many of which are unintentionally misleading. Two common ones run along these lines.

- "For every buyer there has to be a seller"
- "All that is needed to make a market is two traders willing to trade at the correct price"

These statements sound so logical and straightforward that you might read them and accept them immediately at face value, without ever thinking about the logical implications! You are left with the impression that the market is a very straightforward affair, like a genuine open auction at Sotheby's perhaps. However, these are in fact very misleading statements.

Yes, you may be buying today and somebody may be willing to sell to you. However, you might be buying only a small part of large blocks of sell orders that may have been on the market-makers' books, sitting there, well before you arrived on the scene. These sell orders are stock waiting to be *distributed* at certain price levels and not lower.

The market will be supported until these sell orders are exercised, which once sold will weaken the market, or even turn it into a bear market.

So, at important points in the market the truth may be that for every share you buy, there may be ten thousand shares to sell at or near the current price level, waiting to be *distributed*. The market does not work like a balanced weighing scale, where adding a little to one scale tips the other side up and taking some away lets the other side fall. It is not nearly so simple and straightforward.

You frequently hear of large blocks of stock being traded between professionals, bypassing what appears to be the usual routes. My broker, who is supposedly "in the know", once told me to ignore the very high volume seen in the market that day, because most of the volume was only market-makers trading amongst themselves. These professionals trade to make money and while there may be many reasons for these transactions, whatever is going on, you can be assured one thing: It is not designed for your benefit. You should certainly never ignore any abnormal volume in the market.

In fact, you should also *watch closely* for volume surges in *other markets* that are related to that which you are trading. For example, there may be sudden high volume in the options market, or the futures market. Volume is activity! You have to ask yourself, why is the '*smart money*' active right now?

Further Understanding Volume

Volume is not difficult to understand once the basic principles of supply and demand are understood. This requires you to relate the volume with price action. Volume is the powerhouse of the stock market. Start to understand volume and you will start to trade on facts (not on 'news'). Your trading will become exciting as you start to realise that you can read the market – a very precious skill that only a few people share.

To say that the market will go up when there is more buying (demand) than selling – and go down when there is more selling (supply) than buying may seem like an obvious statement. However, to understand this statement you need to look at the principles involved. To understand what the volume is saying to you, you have to ask yourself again, "What has the price done on this volume"?

The price spread is the difference between the highest and lowest trading points reached during the timeframe you are looking at, which may be weekly, daily, hourly, or whatever other timeframe you choose.

Volume shows the activity of trading during a specific period. If the volume is taken in isolation it means very little – volume should be looked at in relative terms. Therefore, if you compare today's volume with volume during the previous thirty days (or bars) it is easy to see if today's volume is high, low or average compared to the volume seen in the past. If you stand thirty people in a line, it is easy for you to see who the tall ones are, compared to the others. This is a skill of human observation, so you will have no problems identifying whether the volume is relatively high, low or average.

Compare this volume information with the price spread and you will then know how bullish or bearish the professional wholesalers really are. The more practice you have, by taking this professional approach, the better you will become.

To make it easier for you to understand volume, compare it to the accelerator of your automobile. Think about the results you would expect from pressing the accelerator when approaching 'resistance', such as a hill. Imagine you are an engineer monitoring a car's performance by remote control. Your instruments only allow you to see the power applied to the accelerator pedal (volume) and a second engineer is looking at the cars actual motion (price movement). The second engineer informs you that the car is moving forward uphill; however, this uphill movement is not in keeping with your observation of power to the accelerator pedal, which you observe is very low. You would naturally be somewhat sceptical, as you know a car cannot go uphill without sufficient power being applied.

You may conclude that this movement uphill could not possibly be a genuine lasting movement, and that it is probably caused by some reason other than power application. You may even disbelieve what your instruments are telling you, as it is obvious that cars cannot travel uphill unless power is applied to the accelerator pedal. Now you are thinking more like a professional trader!

Many traders are mystified if the same thing happens in the stock market. Remember, any market, just like an automobile, has 'momentum' that will cause movement even when the power has been turned off. This example explains why markets can momentarily rise on a low volume up-move. However, all moves with differing types of volume activity can be explained using the "accelerator pedal" analogy.

Footnotes: When observing volume information, keep in mind that this represents the amount of professional activity and little else.

What is Bullish & Bearish Volume?

There are only two basic definitions for bullish and bearish volume:

1. Bullish volume is increasing volume on up-moves and decreasing volume on down-moves.
2. Bearish volume is increasing volume on down-moves and decreasing volume on up-moves.

Knowing this is only a start and in many cases, not a great deal of help for trading. You need to know more than this general observation. You need to look at the price spread and price action in relation to the volume. Most technical analysis tools tend to look at an area of a chart rather than a trading point. That is, averaging techniques are used to smooth what is seen as noisy data. The net effect of smoothing is to diminish the importance of variation in the data flow and to hide the true relationship between volume and the price action, rather than highlighting it!

By using the TradeGuider software, volume activity is automatically calculated and displayed on a separate indicator called the 'Volume Thermometer'. The accuracy of this leaves you in no doubt that bullish volume is expanding volume on up-bars and decreasing volume on down-bars.

The market is an on-going story, unfolding bar by bar. The art of reading the market is to take an overall view, not to concentrate on individual bars. For example, once a market has finished distributing, the '*smart money*' will want to trap you into thinking that the market is going up. So, near the end of a distribution phase you may, but not always, see either an up-thrust (see later) or low volume up-bars. Both of these observations mean little on their own. However, because there is weakness in the background, these signs now become very significant signs of weakness, and the perfect place to take a short position.

Any current action that is taking place cannot alter the strength or weakness that is embedded (and latent) in the background. It is vital to remember that near background indications are just as important as the most recent.

As an example, you do exactly the same thing in your life. Your daily decisions are based on your background information and only partly on what is happening today. If you won the lottery last week, yes, you might be buying a yacht today, but your decision to buy a yacht today will be based on your recent background history of financial strength appearing in your life last week. The stock market is the same. Today's action is heavily influenced by recent background strength or weakness, rather than what is actually happening today (this is why 'news' does not have a long-term effect). If the market is being artificially marked up, this will be due to weakness in the background. If prices are being artificially marked down, it will be due to strength in the background.

Footnotes:

Down-bars: If prices are dropping on volume that is less than the previous two bars (or candles), especially if spreads are narrow, with the price closing in the middle or high of the bar, this indicates that there is 'no *selling pressure*'.

Up-bars: Weakness manifests itself on up-bars, especially when spreads are narrow, with volume less than the previous two bars (or candles). This shows that there is '*no demand*' from professional traders.

Accumulation & Distribution

Syndicate traders are very good at deciding which of the listed shares are worth buying, and which are best left alone. If they decide to buy into a stock, they are not going to go about it in a haphazard or half-hearted fashion. They will first plan and then launch, with military precision, a co-ordinated *campaign* to acquire the stock – this is referred to as *accumulation*. Similarly, a co-ordinated approach to selling stock is referred to as *distribution.*

Accumulation

To ***accumulate*** means to buy as much of the stock as possible, without significantly putting the price up against your own buying, until there are few, or no more shares available at the price level you have been buying at. This buying usually happens after a bear move has taken place in the stock market (which will be reflected by looking at the Index).

To the syndicate trader, the lower prices now look attractive. Not all of the issued stock can be *accumulated* straight away, since most of the stock is tied up. For example, banks retain stock to cover loans, and directors retain stock to keep control in their company. It is the *floating supply* that the syndicate traders are after.

Once most of the stock has been removed from the hands of other traders (ordinary private individuals), there will be little, or no stock left to sell into a mark-up in price (which would normally cause the price to drop). At this point of 'critical mass', the resistance to higher prices has been removed from the market. If accumulation has taken place in lots of other stocks, by many other professionals, at a similar time (because market conditions are right), we have the makings of a bull market. Once a bullish move starts, it will continue without resistance, as the supply has now been removed from the market.

Distribution

At the potential top of a bull market, many professional traders will be looking to sell stock bought at lower levels to take profits. Most of these traders will place large orders to sell, not at the current price available, *but at a specified price range*. Any selling has to be absorbed by the market-makers, who have to create a 'market'. Some sell orders will be filled immediately, some go, figuratively, 'onto the books'. The market-makers in turn have to resell, *which has to be accomplished without putting the price down against their own, or other traders' selling*. This process is known as **distribution**, and it will normally take some time for the process to complete.

In the early stages of distribution, if the selling is so great that prices are forced down, the selling will stop and the price will be supported, which gives the market-maker, and other traders, the chance to sell more stock on the next wave up. Once the professionals have sold most of their holdings, a bear market starts, because markets tend to fall without professional support.

Strong & Weak Holders

The stock market revolves around the simple principles of accumulation and distribution, which are processes that are not well known to most traders.

Perhaps you can now appreciate the unique position that the market-makers, syndicate traders, and other specialist traders are in – they can see both sides of the market at the same time, which represents a significant advantage over the ordinary trader.

It is now time to refine your understanding of the stock market, by introducing the concept of '*Strong and Weak Holders.'*

Strong Holders

Strong holders are usually those traders who have not allowed themselves to be trapped into a poor trading situation. They are happy with their position, and they will not be shaken out on sudden down-moves, or sucked into the market at or near the top. Strong holders are strong because they are trading *on the right side of the market*. Their capital base is usually large, and they can normally read the market with a high degree of competence. Despite their proficiency, strong holders will still take losses frequently, but the losses will be minimal, because they have learnt to close out losing trades quickly. A succession of small losses is looked upon in the same way as a business expense. Strong holders may even have more losing trades than winning trades, but overall, the profitability of the winning trades will far outweigh the combined effect of the losing trades.

Weak Holders

Most traders who are new to the markets will very easily become *Weak Holders*. These people are usually under-capitalised and cannot readily cope with losses, especially if most of their capital is rapidly disappearing, which will undoubtedly result in emotional decision-making. Weak holders are on a learning curve and tend to execute their trades on 'instinct'. Weak holders are those traders who have allowed themselves to be 'locked-in' as the market moves against them, and are hoping and praying that the market will soon move back to their price level. These traders are liable to be 'shaken out' on any sudden moves or bad news. Generally, weak holders will find that they are trading on the wrong side of the market, and are therefore immediately under pressure if prices turn against them.

If we combine the concepts of *strong holders accumulating stock from weak holders prior to a bull move,* and *distributing stock to potential weak holders prior to a bear move*, then in this context:

- A Bull Market occurs when there has been a **substantial transfer** of stock **from Weak Holders to Strong Holders**, generally, at a loss to Weak Holders.

- A Bear Market occurs when there has been a **substantial transfer** of stock **from Strong Holders to Weak Holders**, generally at a profit to the Strong Holders.

The following events will always occur when markets move from one major trending state to another:

The Buying Climax

Brief Definition: An imbalance of supply and demand causing a bull market to transform into a bear market.

Explanation: If the volume is seen to be exceptionally high, accompanied by narrow spreads into new high ground, you can be assured that this is a 'buying climax'.

It is called a buying climax because to create this phenomenon there has to be a huge demand for buying from the public, fund managers, banks and so on. It is into this buying frenzy, that syndicate traders and market-makers will dump their holdings, to such an extent that higher prices are now impossible. In the last phase of the buying climax, the market will be seen to close in the middle or high of the bar.

The Selling Climax

Brief Definition: An imbalance of supply and demand causing a bear market to transform into a bull market.

Explanation: This is the exact opposite of a buying climax. The volume will be extremely high on down-moves, accompanied by narrow spreads, with the price entering fresh low ground. The only difference is that on the lows, just before the market begins to turn, the price will be seen to close in the middle or low of the bar.

To create this phenomenon requires a huge amount of selling, such as that witnessed following the tragic events of the terrorist attacks on the World Trade Centre in New York on September the 11th 2001.

Note that the above principles seem to go against your natural thinking (i.e. market strength actually appears on down-bars and weakness, in reality, appears on up-bars). Once you have learned to grasp this concept, you will be on your way to thinking much more like a professional trader.

Resistance & Crowd Behaviour

We have all heard of the term 'resistance', but what exactly is meant by this loosely used term? Well, in the context of market mechanics, resistance to any up-move is caused by somebody selling the stock as soon as a rally starts. In this case, the *floating supply* has not yet been removed. The act of selling into a rally is bad news for higher prices. This is why the supply (resistance) has to be removed before a stock can rally (rise in price).

Once an up-move does take place, then like sheep, all other traders will be inclined to follow. This concept is normally referred to as '*herd* instinct' (or crowd behaviour). As human beings, we are free to act however we see fit, but when presented with danger or opportunity, most people act with surprising predictability. It is this knowledge of crowd behaviour that helps the professional syndicate traders to choose their moment to make a large profit. Make no mistake – professional traders are predatory beasts and uninformed traders represent the symbolic 'lamb to the slaughter'.

We shall return to the concept of '*herd* instinct' again, but for now, consider the importance of this phenomenon, and what it means to you as a trader. Unless the laws of human behaviour change, this process will always be present in the financial markets. You must always try to be aware of '*Herd* Instinct'.

There are only two main principles at work in the stock market, which will cause a market to turn. Both of these principles will arrive in varying intensities producing larger or smaller moves:

1. The '*herd*' will panic after observing substantial falls in a market (usually on bad news) and will usually follow its instinct to sell. As a trader who is aware of crowd psychology, you must ask yourself, "Are the trading syndicates and market-makers prepared to absorb the panic selling at these price levels?" If they are, then this is a good sign that indicates market strength.

2. After substantial rises, the '*herd*' will become annoyed at missing the up-move, and will rush in and buy, usually on good news. This includes traders who already have long positions, and want more. At this stage, you need to ask yourself, "Are the trading syndicates selling into the buying?" If so, then this is a severe sign of weakness.

Does this mean that the dice is always loaded against you when you enter the market? Are you destined always to be manipulated? Well, yes and no.

A professional trader isolates himself from the '*herd*' and becomes a predator rather than a victim. He understands and recognises the principles that drive the markets and refuses to be misled by good or bad news, tips, advice, brokers, or well-meaning friends. When the market is being shaken-out on bad news, he is in there buying. When the '*herd*' is buying and the news is good, he is looking to sell.

You are entering a business that has attracted some of the sharpest minds around. All you have to do is to join them. Trading with the 'strong holders' requires a means to determine the balance of supply and demand for an instrument, in terms of professional interest, or lack of interest, in it. If you can buy when the professionals are buying (accumulating or re-accumulating) and sell when the professionals are selling (distributing or re-distributing) and you do not try to buck the system you are following, you can be as successful as anybody else can in the market. Indeed, you stand the chance of being considerably more successful than most!

Supply & Demand

We can learn a great deal from observing the professional market operators.

If you watch a top professional trading and he is not on the floor, he will most likely be looking at a trading screen, or a live chart on a computer screen. On the face of it, his resources are no different from any other trader. However, he does have information on the screen you are not privileged to see. He knows where all the stops are, he knows who the large traders are and whether they are buying or selling. He has low dealing costs compared to you. He is well practised in the art of trading and money management.

What does he see? How does he manage to get a good position when, by the time you get to the market, prices always seem to be against your interests? How does such a trader know when the market is going to move up or down? Well, he understands the market and uses his knowledge of volume and price action as his primary cues to enter (or exit) the market.

His primary concern is the state of *supply and demand* of those instruments in which he has an interest. One way or another, the answers lie in some form of analysis of trading volume, price action and price spreads. Here at TradeGuider Systems Ltd, we have developed a methodology called Volume Spread Analysis (abbreviated to VSA), which has been built into the computer model that is utilised in the TradeGuider software.

Learning which questions to ask and how to obtain the answers requires us to look more deeply into the markets. The stock market becomes far more interesting if you have some idea what is going on and what is causing it to go up or down. A completely new and exciting world can open up for you.

Nearly all traders use computers and many of these traders are using Technical Analysis packages. They will have learned how to use well-known indicators, like RSI and Stochastics, which are mathematical formulae based on a historical study of price. Some packages have over 100 indicators and other tools that measure cycles, angles, or retracements. There is even software that analyses the effects of tidal forces, astrological, planetary, and galactic influences. To many traders, these methods will have a place in their trading decisions, because they will be familiar with their use. However, it can become a very frustrating business being placed outside of the market looking in, using these tools, trying to decide if the market is likely to go up or down. The fact is, these tools never tell you *why* the market is moving either up or down – that, in most cases remains a complete mystery.

People, unless they are naturally well disciplined, are extremely open to suggestion! Folks like to be given tips, listen to the news stories, seek out rumours in internet chat rooms, or maybe subscribe to *secret* information leaked from *unknown* sources.

For the most part, professional floor traders, syndicate traders, and the specialists, do not look at these things. *They simply do not have the time*. Professionals have to act swiftly, as soon as market conditions change, because they are up against other professionals who will act immediately against their interests if they are too slow in reacting to the market. The only way they can respond that fast is to understand and react, almost instinctively, to what the market is telling them. They read the market through volume and its relationship to price action.

You, too, can read the market just as effectively, but you have to know what you are looking at, and what you are looking for.

TradeGuider

The principal purpose of this book has been to enhance your ability to understand and read the stock market by using the knowledge, research and methodologies provided by TradeGuider Systems Ltd – we hope that you have enjoyed reading it. However, the book would not be complete without at least a brief outline of the main features of the computer program that has been created by TradeGuider Systems Ltd. TradeGuider has been developed to translate our proprietary VSA™ (Volume Spread Analysis™) methodology into signals that appear automatically. The accuracy of these signals is surprising to most traders. Since this is possible, then it must show that the methodology has substance, and represents the basis of how the markets really work.

Summary

Our VSA software, on which TradeGuider is based, has already won the acclaim of several respected financial magazines and newspapers:

- John Sweeney from "*Stocks and Commodities Magazine*" is quoted as saying, "**the best intraday signals ever seen.**"

- Andy Webb from "*Investors Chronicle*" said, "**I am aware of several professional traders who use the software with great success on a daily basis. In fact, it is only a few weeks since I sat and watched an – admittedly highly skilled – trader who was using the software to make more than £10,000 in less than half an hour.**"

- Sunday Business wrote, "**The software has a following among some very successful users. A case in point is Martin Cole, former proprietor of a building plastics firm, who now trades full-time from a mountaintop in southern Spain**".

Using artificial intelligence to evaluate a unique blend of over 400 proprietary indicators, TradeGuider represents the culmination of over 30 years of research and development. The analysis methodology used by TradeGuider is far removed from other products; it is built around the complex interactions of price, spread and volume. This multidimensional approach to analysis, combined with the 'intelligence' built into the Expert System, means that we can offer traders a robust methodology that works in any liquid market and any timeframe.

There are two major factors that set TradeGuider apart from all the other trading software providers:

1. TradeGuider is a revolutionary piece of technology that is able to identify the many tactics practised by the "*smart money*".

2. TradeGuider is the only trading software in the world, which generates a comprehensive set of indicators that are wholly based on the principles of supply and demand, rather than the traditional mathematical formulas that are oriented around historical studies of price.

Brief Description

Below is a brief description of the TradeGuider software:

- TradeGuider is unique. Driven by an artificial intelligence engine, the software is capable of analysing any liquid market, extracting the information it needs to indicate imbalances of supply and demand on a chart – *the essential force that moves every market.*

- The software works in either real-time or end-of-day modes, and shows when professional money is entering, exiting, or withdrawing from the market, enabling you to make more intelligent, timely, and informed decisions.

- The software combines ease of use with superb supply and demand analysis. The extensive Expert System has an innate understanding of market dynamics combined with volume, which means that it is capable of analysing supply and demand in any liquid market.

- The indicators are displayed automatically on the chart. There is no configuration, no setting of parameters, and no optimization. Our methodology is robust and can be applied to any timeframe or tick-frame, with consistent results.

- The sophisticated Expert System is augmented by a novel set of proprietary tools, including indicators that show bullish and bearish volume, automatic support and resistance levels, trend clusters, automatic trend channels and an 'instant trend' indicator.

- TradeGuider is a revolutionary concept that can be used on its own, or as a volume-based decision support system. It can be used in conjunction with other trading software, such as MetaStock, OmniTrader, and TradeStation. TradeGuider can also add value to the regular technical analysis tools found in data vendor platforms, such as eSignal, RealTick and QCharts.

Features List

Superb Supply and Demand Indicators
Indicators are automatically displayed on the chart as soon as the Expert System detects a confirmed sign of market strength or weakness. The indicators require no configuration or parameterization of any kind.

Market Directional System
TradeGuider uses a very effective trending system to colour the individual price bars red and green to show which direction the market is moving.

Proprietary Tools
TradeGuider has a number of unique tools that will help you in ‘pulling the trigger’. These include a bullish/bearish volume indicator, ‘instant trend’ indicator and a mechanical stop/reverse system that is always ‘in the market‘.

Automatic Trading Channels
TradeGuider uses a proprietary method of calculating and displaying the currently active trading channel. You can alter the sensitivity of this feature according to your trading style.

Support **&** Resistance **Analysis**
You can easily see where support and resistance exists on your chart by asking TradeGuider to display the important price levels. A proprietary method is used to identify support and resistance very accurately. This feature can be configured according to your preferences.

Technical Analysis Tools
Popular technical analysis tools are built into TradeGuider to supplement your trading decisions. Amongst the tools provided, you'll find 4 different types of moving average (simple, variable, weighted, exponential), envelopes (trading bands), Bollinger bands, Fibonacci Retracements, Percentage Retracements, RSI, MACD, Stochastics, ADX, DMI, Pivot Points, Trend Lines, Channels and Horizontal lines.

Unique Stop-loss Systems
TradeGuider employs the use of a unique stop-loss system (called a dynamic stop-loss) that 'breathes' with the market, allowing you to maximize your time in the trade, whilst protecting your exposure at the same time. Once the stop level is triggered, you are notified immediately by a synthesized voice.

Trade Monitoring System
At any stage, TradeGuider can give you any immediate assessment of the current profit or loss incurred on a trade, via the Trade Monitoring System, which is able to track all open trades and display a on-screen summary.

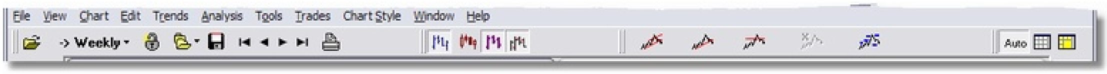
Trading History Report
A Historical Report shows key information for all your trades in a particular instrument. At a glance, you can see the number of winning and losing trades, gross gain/loss compared to trading costs, percentage of winners to losers, and total profit against total loss.

Voice Synthesis Alert System
Professional voice synthesis technology is used to provide voice alerts for all the primary systems and technical analysis tools, keeping you fully informed of changes in the market environment at all times.

Signal Scan Capability
TradeGuider is able to perform a signal scan, showing you all prospective instruments that are likely to show a price move, due to an imbalance of supply and demand.

Product Detail

A Simple and Completely Configurable Display Environment.



Although TradeGuider harnesses a huge amount of analysis power, the program is easily controlled via a set of toolbars. The toolbars can be placed anywhere around the perimeter of the screen and can be switched on or off according to the user's individual requirements. All vital functions can be accessed via a single 'click' of the mouse.

A Refreshingly Clean Presentation that is Easy on the Eye

TradeGuider's charts are a pleasure to work with, displaying intuitive bar colouring to show trend direction. The supply and demand indicators are coloured green or red (green for strength and red for weakness).

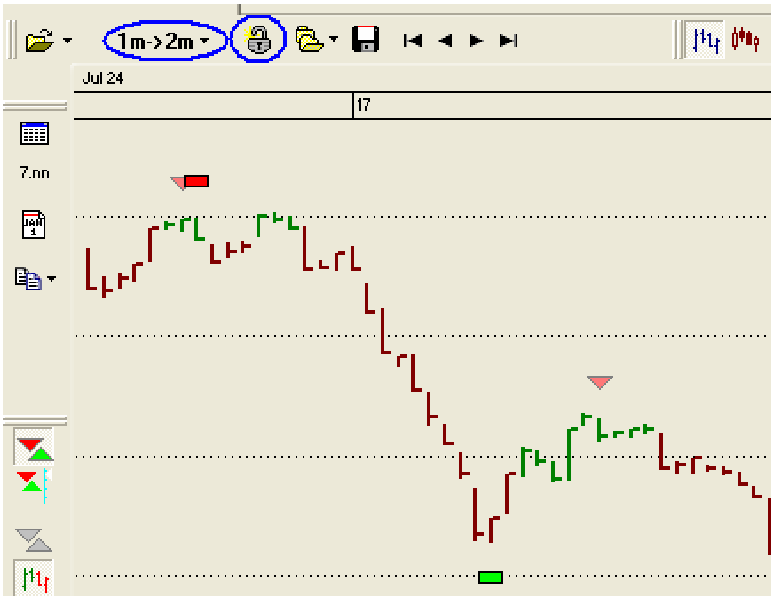
The relative amount of bullish or bearish volume is displayed on a vertical gauge to the right of the screen. Technical analysis studies are displayed at the bottom of the screen alongside the volume histogram.

Monitor Multiple Markets and Multiple Timeframes

TradeGuider is able to monitor several markets simultaneously, and is equally adept at monitoring multiple timeframes, catching key moves as they happen.

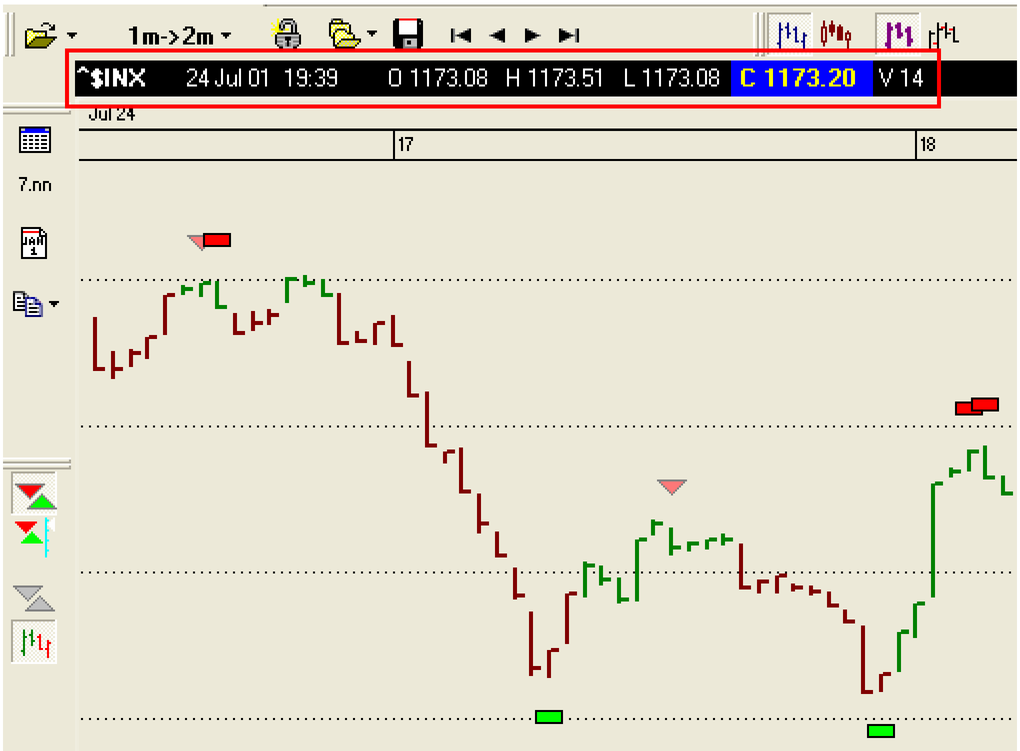
Change Timeframes 'On the Fly'

Timeframes can be changed 'on the fly'. Just point and click, and TradeGuider will instantly perform a new analysis. And if you prefer your 1 minute chart to be 'locked' as a 2 minute chart, just click the padlock button and TradeGuider will remember your preference for later.



The Info Bar

All critical information is displayed on-screen. The **Info Bar** feature shows the Symbol Name, Date/Time, OHLCV Data, Live Price and Stop Levels so that they are immediately accessible, all the time.



All the technical indicators use the Info Bar idea too.

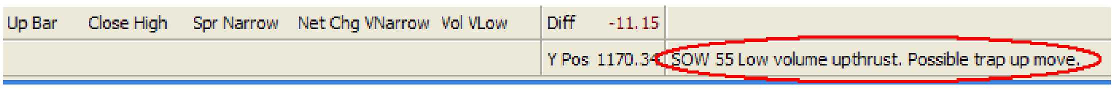
Here you can see the Info Bar for the RSI indicator.

The Status Bar

The **Status Bar** shows information fed back from TradeGuider's Expert System.

Here we can see that the software has identified a 'Trap Up-move', which is a frequent and dangerous tactic that market-makers love to pull on the unwary trader!

The information is immediately shown on the Status Bar, as "*Low volume* up-thrust. *Possible trap up-move*".

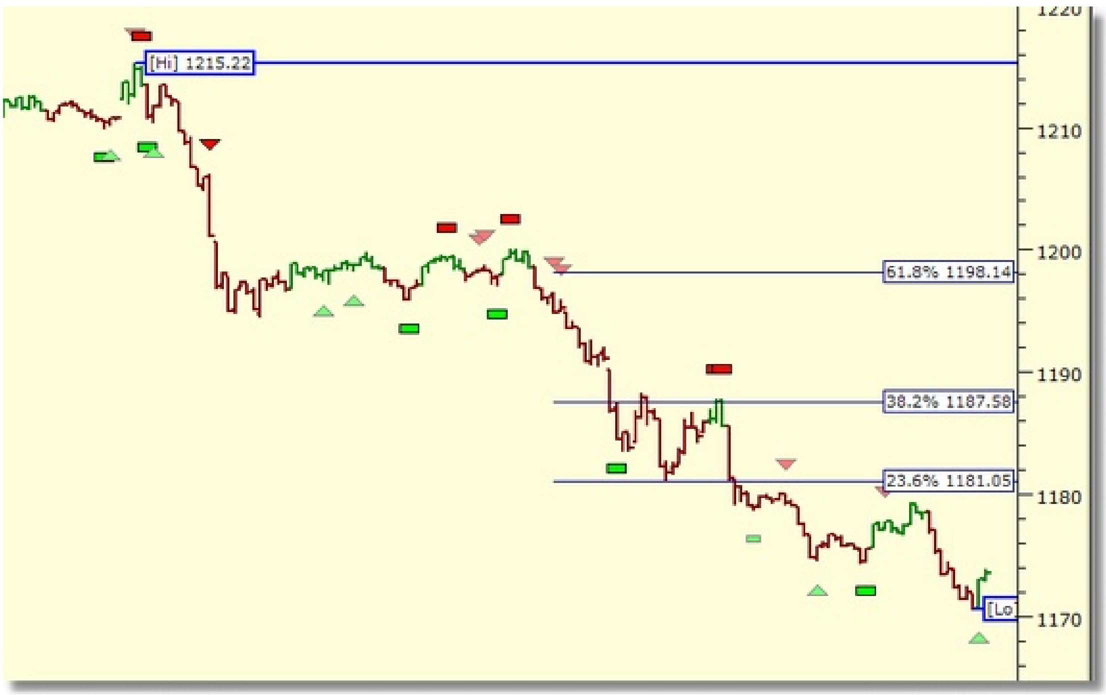


Important Price Levels

TradeGuider shows all critical price levels directly on the chart, so it is possible, in real-time, to know the exact level of stops, support/resistance lines, pivot levels, and Fibonacci retracements.

Here is an example of the Pivot Point feature, showing key support and resistance levels, and how the supply/demand indicators can be used to confirm the levels.

The screenshot below shows how effective the indicators are around Fibonacci price levels.



Support and Resistance within a Trading Channel

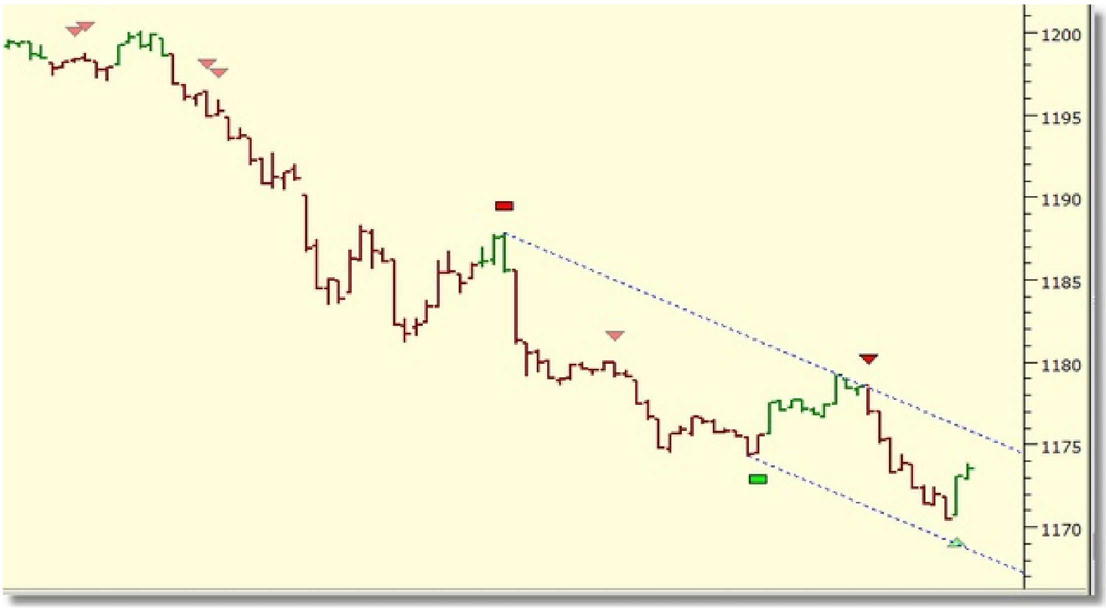
Trading Channels often manifest support/resistance levels around the top and bottom quarters of the channel. The screenshot below shows TradeGuider displaying these points and the way that supply/demand indicators coincide with the channel boundaries.

Supply and Demand Indicators Coinciding with Trend Lines

Traditional technical analysis, such as the art of drawing trend lines, is still a valid part of market study within the TradeGuider software. Here we can see how often supply and demand indicators coincide with trend line boundaries.

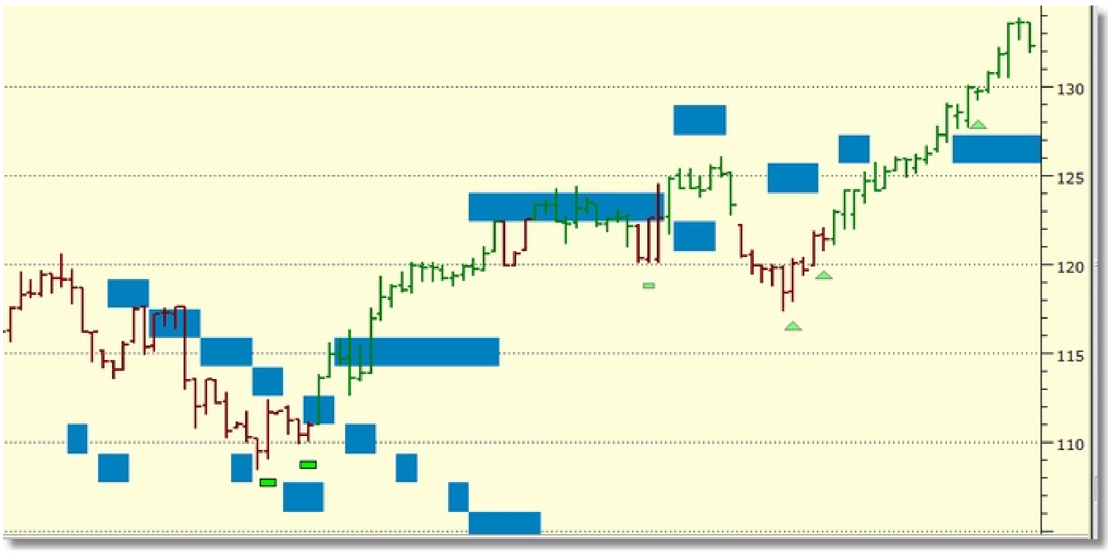
Automatically Display the Last Active Trend

Not everyone is adept at drawing trend lines – that is why we have implemented a feature to display the last active trend, making it easy for the novice to use, whilst saving time for the more experienced trader.



Show Strong Areas of Support and Resistance with Trend Clusters

The Trend Cluster feature is able to provide a visual indication of strong areas of support and resistance on a chart. Prices frequently refuse to break through trend clusters, often dodging and meandering around the blocks. However, when price action breaks through a cluster, especially if accompanied by wide spreads and high volume, we can usually look forward to a sustained move until the next cluster level is hit.

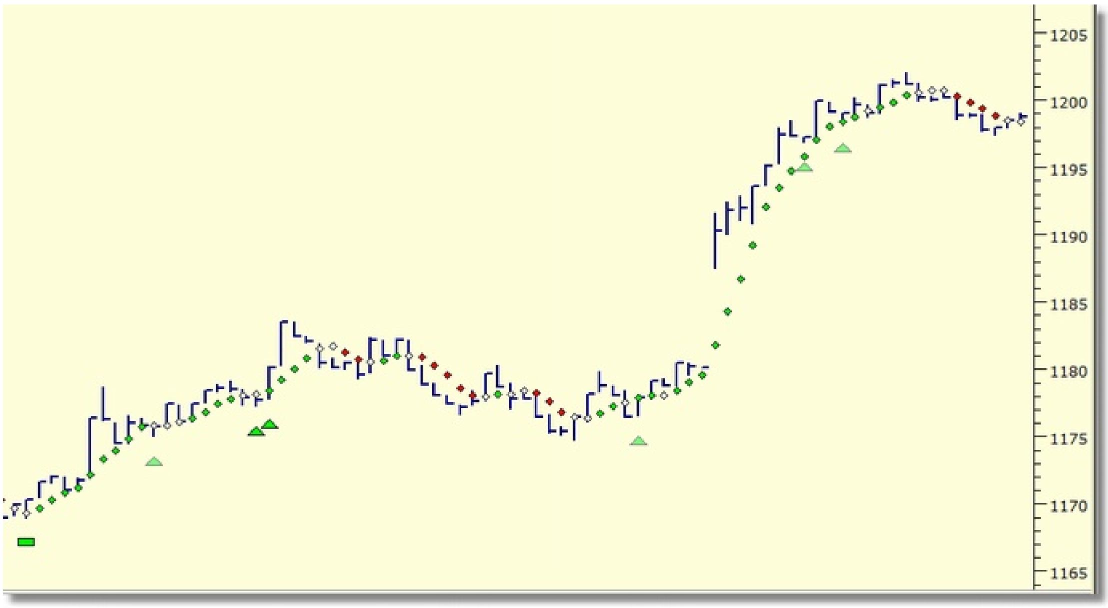


Automatic Support and Resistance Lines

Support and Resistance lines are notoriously difficult for the newcomer to master, so TradeGuider has been designed to show them automatically. Supply and demand indicators will often coincide with these lines, helping to confirm whether a move will hold or turn.

Instant Trend Indicator

TradeGuider is able to indicate the trend direction visually using our instantaneous trend technology. Small diamonds are overlaid onto the chart, which change colour dependent on trend direction. Green diamonds show that the trend is up, white diamonds show that the trend is starting to change and red diamonds indicate that the trend is down.



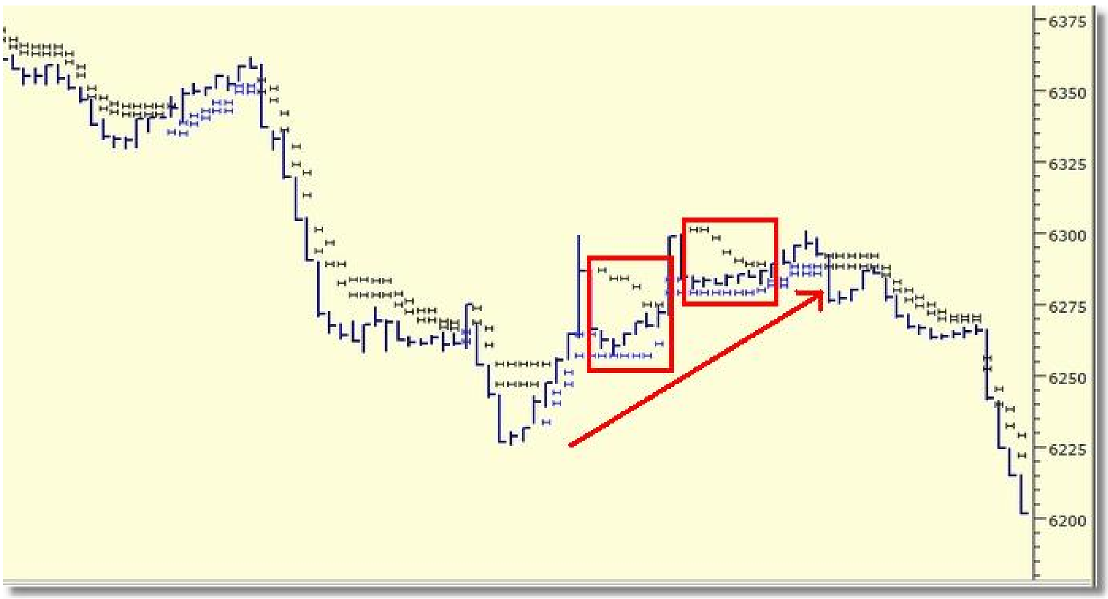
Trend Signals

Apart from the supply and demand signals, TradeGuider can also show trend indicators that show the anticipated market direction. The trend indicators take into account the amount of market volatility, making them less reactive in volatile conditions and more sensitive in smoother markets. The blue markers on the chart below represent the trend signals.

Built-in Congestion Identification

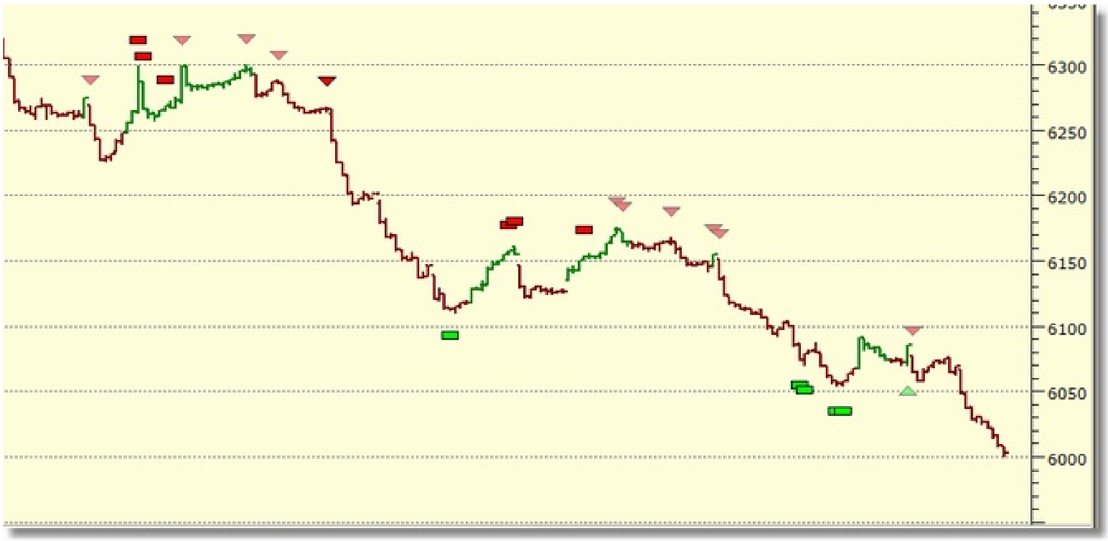
TradeGuider is able to identify periods of potential congestion and display them on a chart. This assists the trader by helping him to ride through risky congestion areas and benefit from the full potential of a move, without succumbing to the effects of minor whipsaw.

The screenshot below shows red rectangles where congestion was identified and the arrow shows the full extent of the move if the trader had held on through the congestion.



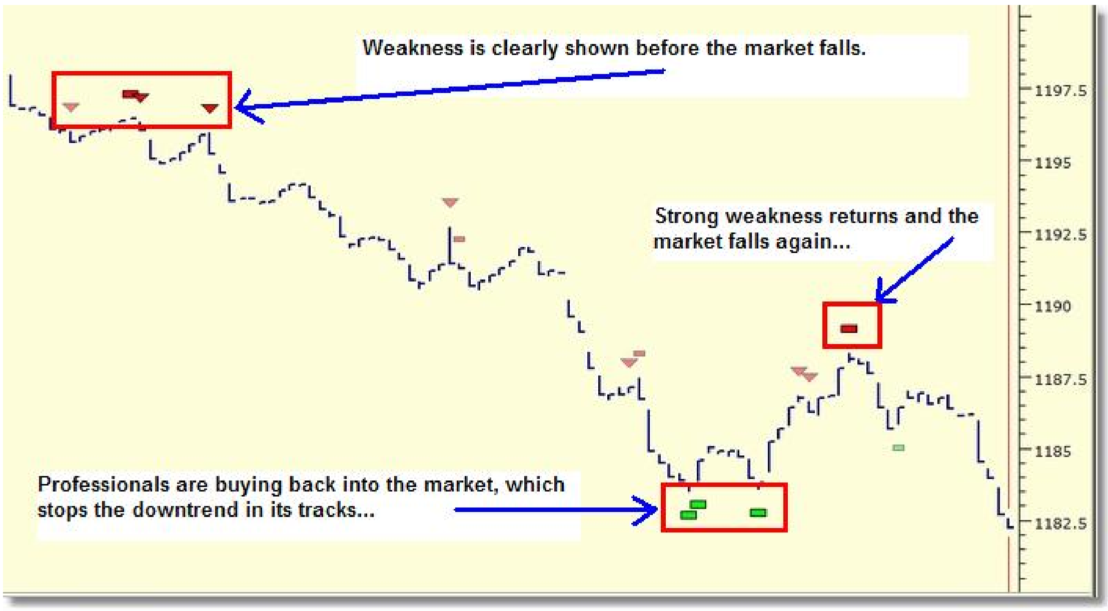
The Visual Impact of Supply and Demand Indicators

TradeGuider represents a major step forward for traders and investors, providing information in visual form, representing imbalances of supply and demand in the market. The chart below shows a market flooded with supply (indicated by the predominance of red markers) – only the very brave would go long in these conditions.



See the Intensity of Professional Activity in Visual Form

TradeGuider is armed with nearly 400 supply and demand indicators, which makes it an effective, ultra-sophisticated guidance tool. TradeGuider can even show you the anticipated intensity of professional activity and where it happens on your chart.



The meaning of the symbols is detailed below:

Red/Green Rectangles

Rectangles represent strong weakness (red) or strength (green) respectively. When TradeGuider displays a red or green rectangle, there is a good chance that the current price move will stop and reverse. If this does not happen, the market will usually stop trending and move sideways for a while. Sometimes rectangles are seen during a trending market as the professionals are either buying into or selling into the market (i.e. Accumulating or distributing). Referring to the chart at the bottom of the previous page, see how the professionals sell the market at the top left of the chart, which causes prices to fall (note the red rectangle amongst the other signs of weakness)? At the bottom of the downtrend, note the three green rectangles denoting heavy buying at this price level. The market rises on this strength and is then countermanded by a red rectangle, which causes a resumption in the downtrend.

Red/Green Triangles

Triangles denote an intermediate chance of a correction (down-move) or reaction (up-move) in the market. When more than one of these symbols occur in close proximity to one another, especially if a rectangle is in the near background (last 10 bars), this adds extra strength or weakness to the situation.

Note: A series of strength (or weakness) symbols that appear together, indicate an accumulation of strength or weakness. In the example at the bottom of the previous page, this principle is demonstrated by four signs of weakness (top left), which results in a large fall in price.

Pale Coloured Red/Green Triangles & Small Rectangles

These symbols all denote subtle changes in supply and demand factors. More than likely, there will not be an immediate move in the market when these symbols are shown. We debated whether to show our clients these subtle changes, but eventually decided that there was some value in giving this information, as in our opinion, it is always better to be fully informed. Note the subtle signs of weakness in the chart at the bottom of the previous page (left of centre) – the market falls off soon after. There are more subtle signs of weakness right of centre and this time the market drops immediately. Finally, there are two more subtle signs of weakness that appear before the red rectangle at the right of the chart: These should act as warnings, especially, when followed by a red rectangle as in the example above.

Using TradeGuider with Technical Analysis Indicators

The supply and demand indicators that are built into TradeGuider can be used in conjunction with standard technical analysis techniques. In this way, our indicators are a valuable addition to any trading system, as they act as confirmation of a likely move.

The screenshot below shows TradeGuider's indicators in conjunction with ADX (yellow markers). In this example, the ADX signals appear after the supply and demand indicators, and confirm the likely direction of future price movement. There is one ADX signal on the left of the screen that is not confirmed by TradeGuider's indicators – as can be seen, the resultant move from this unconfirmed indicator is negligible.

Data Provision

There are three versions of TradeGuider available:

1. **TradeGuider EOD**

   TradeGuider EOD requires an end-of-day (EOD) data feed service that supplies data in CompuTrac or MetaStock format. We recommend good quality data services like Reuters DataLink and CSI Data.

2. **TradeGuider RT (for eSignal)**

   eSignal provides real-time market data and decision support tools to active investors.

   eSignal, is a leading real-time quote service that delivers continuously updating, time-sensitive financial data over the Internet to active traders' and individual investors' PCs or laptops. The software provides market quotes for stocks, options and futures, among others, as well as charts, news, research, alerts, back-testing, a formula engine for developing chart studies and integrated trading to a choice of direct access brokerages, to the growing base of online investors.

   eSignal brings you data from all the major US, Canadian, and European exchanges. The service is available in a number of different configurations and includes the following:

   • US and European Futures, Options & Equities Access
   • US and European Indices Access
   • Limit of 500 concurrent symbols

   TradeGuider is fully integrated with eSignal. We are an approved eSignal partner, which means we are able to offer you very attractive monthly subscription rates. You may qualify for a free trial period if you have never used the eSignal service before.

3. **TradeGuider RT (for RealTick)**

   RealTick offers TAL Data™ – fast, reliable market data that Townsend Analytics provides to online traders, broker dealers and financial institutions worldwide. This data includes streaming real-time data on stocks, futures, equities, options and foreign currencies from all the major exchanges.

   TAL Data Provides independently generated indices (Gap Open, Percent Weekly Volume, Gainers, Losers, Most Actives, and 52-week Highs and Lows), which update every minute throughout the trading day. This data is *distributed* direct to you via the internet.

   RealTick offers flexibility, both in its user interface and the variety of add-ons that you can choose for your subscription. Customize your trading platform according to your strategies, and get an expansive view of the market.

For more information, visit our website:

www.tradeguider.com/datafeeds