

Think of zero-sum markets as a tug-of-war while equities and other markets are a game of musical chairs. In a zero-sum market, whoever has the force in the market will ultimately determine where prices will go. In equities, whoever is holding the shares (or product) when the music stops is left holding the bag. You can own a share of stock until it reaches zero no matter how many people owned it before you or how much they made as the price changed. In a zero-sum market, you eventually have to let go of the rope or you might be liable for a huge amount of money as your positions change in value. Later, when we discuss leverage and forced liquidation, how the difference between a tug-of-war and musical chairs plays out in price action will become clearer. In musical chairs, there is one eventual loser: the last buyer. In a tug-of-war, everybody on the wrong side of the market force loses.

Part of what helped me develop a better understanding of how this market force plays out was a thought experiment I did trying to answer the question Who is the force in the market? This dramatically changed how I saw prices and what those price changes mean.

Suppose there are two groups of people in the market, the professional traders who can do size (meaning a lot of contracts at one time) and everybody else. Let's say there is one trader who can do a 100-lot position. At the same time this trader decides to buy the market, there are 99 one-lot traders who wish to sell. It is unlikely that all 99 one-lot traders will wish to enter the market at the same time, so the large trader has to be content with putting the position on one contract at a time. In order to draw in all 99 one-lot traders, the price will need to decline so that the one-lot traders believe they are seeing a trend develop lower. So the 100-lot trader keeps buying a little at a time as the market falls in price until all the little traders are committed to the short side.

At this point, the large trader likely has an open trade loss as the average position has been bought in a declining market. However, a few of the early small traders will have an open trade gain. At this point, the large trader (who is the dominant force in the market) has the advantage. The reason is simple: The large trader is not going to sell the position; the large trader intends to wait out the smaller trader.

As the first group of smaller traders decide to buy back their shorts, their buy orders are not met with a sell order from the larger trader. Hence, the market goes looking for more sell orders above the market—but there are none. So the market rallies higher, erasing the open trade gains of the small traders. The late small sellers are holding losses. Because the one individual holding all the size in the market has decided not to sell,

the 99 small traders are not in control as they all seek to liquidate. Once the price reaches a level where the large trader has an open trade gain and all the small traders wish to buy back their losing shorts, the large trader sells the 100 contracts one at a time to all the losing traders. In the end, the large trader who controlled the size determined where the market would go in price. It was when the small traders all decided it was time to take their losses that the market had buy orders for the large trader to sell against. Obviously, in an active and liquid market, there are always buy and sell orders coming into the machine, but the basic premise is the same.

If you think this through, you will begin to see that trading a zero-sum market is not about the price but about the people who control the size. When we get to market structure, in Chapter 3, we will discuss the difference in the people who control size and everybody else.

After I learned to see a zero-sum market as a tug-of-war, it became very clear that I needed to understand volume and professional activity. Learning to see the market differently led me down a different path to analysis.