Trading By Price

Trading by price -- and "volume" (or trading activity) -- requires a perceptual and conceptual readjustment that many people just can't make, and many of those who can make it don't want to. But making that adjustment is somewhat like parting a veil in that doing so enables one to look at the market in a very different way, one might say on a different level.

One must first accept the continuous nature of the market, the continuity of price, of transactions, of the trading activity that results in those transactions. The market exists independently of you and of whatever you're using to impose a conceptual structure. It exists independently of your charts and your indicators and your bars. It couldn't care less if you use candles or bars or plot this or that line or select a 5m bar interval or 8 or 23 or weekly or monthly or even use charts at all. And while you may attach great importance to where and how a particular bar -- or candle -- closes, there is in fact no "close" during the market day, not until everybody turns out the lights and goes home.

Therefore, trading by price and volume, or at least doing it well, requires getting past all that and perceiving price movement and the balance between buying pressure and selling pressure independently of the medium used to manifest or illustrate or reveal the activity.

For example, the volume bar is a record of transactions, nothing more. The volume bar does not "mean" anything. It does not predict. It is not an indicator. Arriving at this particular destination seems to require traveling a tortuous route since so few are able to do it. But it's a large part of the perceptual and conceptual readjustment that I referred to earlier, i.e., one must see differently and one must create a different sense of what he sees, he must perceive differently and create a different structure based on those perceptions. As long as one believes, for example, that "big" volume must or at least should accompany "breakouts" and clings to this belief as ardently as he clings to his rosary beads or rabbit's foot or whatever, he will be unable to make this perceptual and conceptual shift.

If you can work your imagination and use it to travel in time, you will have a far easier time of this than most. Imagine, for example, a brokerage office at the turn of the 20th century. All you have to go by is transaction results -- prices paid -- on a tape. No charts. No price bars. No volume bars.

You are then in a position wherein you must decide whether to buy or sell based on price action and your judgment of whether buying or selling pressures are dominant. You have to judge this balance by what's happening with price, e.g., how long it stays at a particular level, how often price pokes higher, how long it stays there, the frequency of these pokes, their pace, at what point they take hold and signal a climb, the extent of the pokes, whether or not they fail and when and where, etc., all of which is the result of the balance between buying and selling pressures and the continuous changes in dominance and degree of dominance.

One way of doing this using modern toys and tricks is to watch a Time and Sales window and nothing else after having turned off the bid and ask and volume. But this wouldn't do you any good unless you spent several hours at it and no one is going to do that. Another would be to plot a single bar for the day and watch it go up and down, but nobody's going to do that, either. Perhaps the least onerous exercise would be to follow a tick chart, set at one tick. Then follow it in real time. Watch how price rises and falls due to imbalances between buying pressure and selling pressure. Watch how and where these waves of buying pressure and selling pressure find support and resistance to their movements. And when I say "watch", I mean just that. Don't worry about what you're going to do about whatever it is you're looking at. Don't worry about where you'd enter or where you'd exit or how much money you'd make or whether you'd have been right or wrong to do whatever. Just watch. Like fish in an aquarium. If that seems only slightly less exciting than watching concrete harden, or it's just not possible for you to watch this movement in real time, then collect the data and replay it later at five or ten times normal speed. You can do an entire day in little more than half an hour (though you won't get any sense of real-time pace).

Granted this means a lot of screen time, even in replay, and only a handful of people are going to do it. But those few people are going to part that veil and understand the machinery at a very different level than most traders.

Once the continuous nature of these movements is understood, the idea of wondering -- much less worrying -- about what a particular volume bar "means" is clearly ludicrous, as is the "meaning" of a particular price bar or "candle" (including where it "opens" and "closes" and what it's high is and so forth). If this is not understood, then the trader spends and wastes a great deal of time over "okay so this volume bar is higher than that volume bar but lower than this other volume bar, and price is going up (or down or nowhere), so...".

Auction Markets

I read somewhere recently -- and can't remember where -- having to do with Market Profile, I believe -- that most experienced traders will avoid trying to catch the tops and bottoms and focus on "the middle", waiting for confirmations to enter and confirmations to exit. However, since "the middle" is by definition where most of the trading is going on and is largely non-directional, there is also a lot of whipsawing in the middle, and that generates a lot of losing trades. One can sometimes avoid this by widening the stops, but, since the market always teaches us to do what will lose the most money, this will turn out to be an unproductive tactic.

The safest and generally most profitable trades are found at the extremes. Therefore, you wait for the extremes. Wyckoff used a combination of events to tell him when a wave was reaching its natural crest or trough: the selling/buying climaxes, the tests, higher lows/lower highs, and so on, all confirmed by what the volume was doing and by the effect the volume had on price (effort and result). As a result of this work and of his exploration of trading ranges, he developed the concepts of support and resistance along with their practical application. Auction Market Theory (AMT) takes these investigations into support and resistance further, an “organic” definition of support and resistance like Wyckoff’s, that is, determined by traders’ behavior, not by a calculation originating from one’s head or from a website somewhere. Determine whether you are trending or “balancing” (ranging, consolidating, seeking equilibrium, etc), determine the limits of the range (support and resistance), and you’re in business.

The notion of support and resistance has been and is the missing piece for many market practitioners. One can try to hit what appear at the time to be the important swings again and again and be stopped out again and again, hoping all the while that once one hits the true turning point, all the effort will turn out to have been worthwhile and the P&L will change from red to black. But by waiting for the extremes, one avoids most or all of those losing trades, and, even more important, avoids trading counter-trend.

These boxes -- which are simply a graphic variation of the Market Profile distribution curve, whether skewed or not, or of the VAP (Volume at Price) pattern -- are nothing more than a means of locating those extremes. What I've found more useful about them is that they are encapsulated by time, i.e., the price and volume ranges have a beginning and an end. This enables me to see at a glance where the important S&R are, or at least are likely to be. Without them, one ends up with line after line after line until the S/R plots become a parody of themselves.

All of this can be very confusing to someone who's learned to view the market in a different way, perhaps less so to someone who's just starting since he has so much less to unlearn. But backing up to the basic tenets of AMT, as well as to the concepts developed by (and in some cases originated by) Wyckoff, one can perhaps find a solid footing and proceed from there.

To begin with, in the market, price is often not the same as "value". In fact, one could say that since the process of "price discovery" is a search for value, they match only by accident, and then perhaps for only an instant. Blink and you missed it. Add to this the fact that for all intents and purposes there is no such thing as "value" but rather the perception of value. After all, what is the "value" of, say, Microsoft or GE or that little stock your stylist told you about? This state of affairs may seem like a recipe for chaos, but it is in fact the basis for making a market, that is, reconciling the differences – sometimes extraordinarily wide differences – in perceptions of value.

As Wyckoff put it, if a stock (or whatever) is thought to be below "value" and a trader or group of traders see a large potential for profit ahead, he/they will buy all they can at or near the current level, preferably on "reactions" (or pullbacks or retrenchments), so they don't overpay. If the stock is above the perceived value they'll sell it (or short it), supporting the price on those pullbacks and unloading the stock on rallies until they are out (or as much out as they can be before the thing begins its downward slide). "This", he writes, "is why these supporting levels and the levels of resistance (a phrase originated by me many years ago), are so important for you to watch."

When price then begins to lose momentum and move in a generally sideways direction, you've found "value" (if value hasn't been found, then price won't stop advancing or declining until it has). Value, then, becomes that area where most of the trades have been or are taking place, where most traders agree on price. Price shifts from a state of trending to a state of balancing (or consolidation or ranging), the only two states available to it.

The trading opportunities come

(a) When price is away from value and

(b) When price decides to shed its skin and move on to some other value level (that is, there's a change in demand).

This is also where it gets tricky, partly because demand is ever-changing, partly because you've got multiple levels of support and resistance to deal with and partly because we trade in so many different intervals, from monthly to one-tick. If we all used daily charts exclusively, it would all be much simpler, though not necessarily easier. But that's not the case, so we must remember always that a trend in one interval – say hourly – may be a consolidation in another, such as daily. The hourly may be balancing, but there are trends galore in the 5m chart or the 5s chart.

Or the tick chart. Regardless of how one chooses to display these intervals – line, bar, dot, candle, histogram, etc – there are multiple trends and consolidations going on simultaneously in all possible intervals, even if they're in the same timeframe, even if that timeframe is only one day (to describe this ebb and flow, Wyckoff used an ocean analogy: currents, waves, eddies, flows, tides).

To sum up where we are so far, and keeping in mind that there is no universally-agreed-upon auction market theory, the following elements are, to me, basic, and are consistent with what I've learned from Wyckoff:

1) An auction market's structure is continuously evolving, being revalued; future price levels are not predictable

2) An auction market is in one of two conditions: balancing or trending.

3) Traders seek value; value is price over time; price is arrived at by negotiation between buyers and sellers.

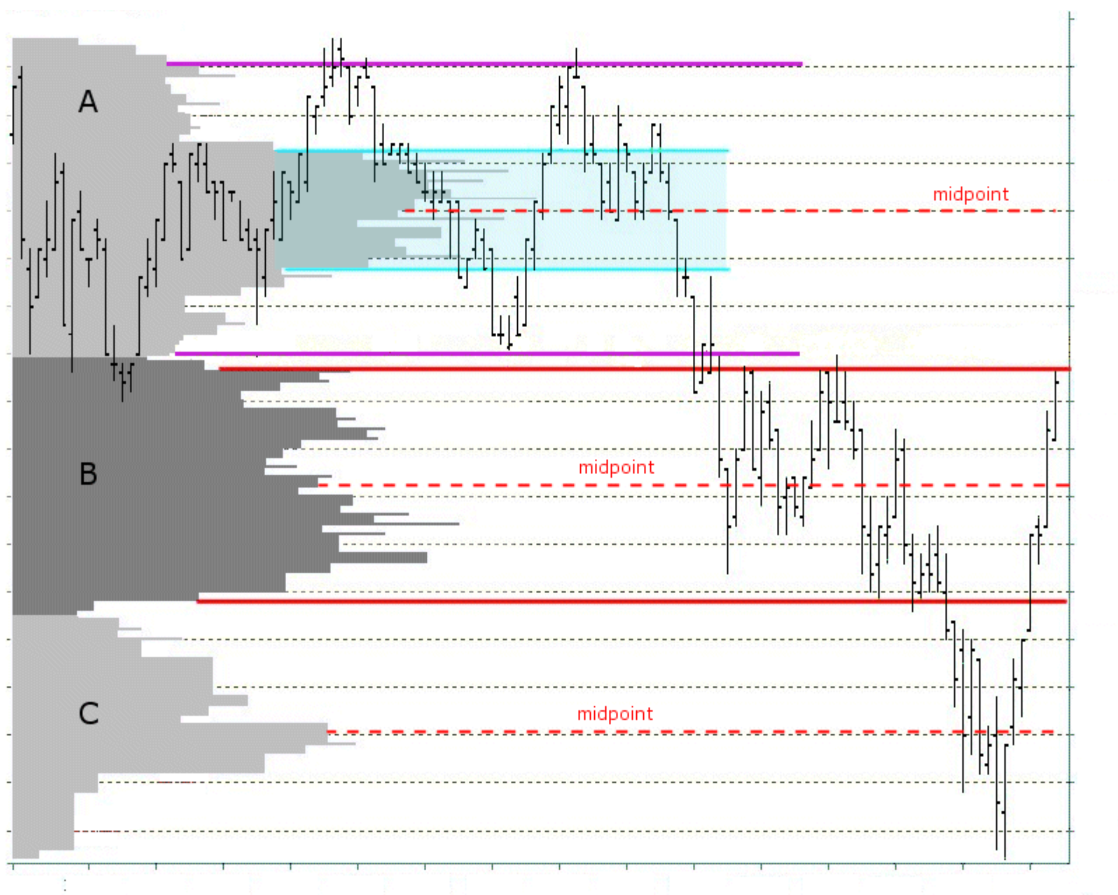
4) Change in demand drives change in price.

5) One can expect to find support where the most substantial buying has occurred in the past and resistance where the most substantial selling has occurred.

Now let's translate all of this into a chart.

I'm sure everyone has noticed that swing highs and lows and the previous days' highs and lows and other /\ and \/ formations can serve as turning points and appear to act as resistance. However, this type of resistance stems from an inability to find a trade and is accompanied by low volume*. Price then reverts to an area where the trader finds it easier to close that trade. That's what provides that ballooning look to the volume pattern "A" in the following chart. "Resistance" in this sense, then, refers to resistance to a continuation of the move, whether up or down.

Volume may look "big" at the highs and lows, but the price points are vertical, not horizontal (as they would be in a consolidation), so the volume – or trading activity – at each price point is lesser than it would be if the same price were hit repeatedly (again, as it would be in a consolidation).



Note that you may have more than one "**zone of concentration**" (this is how jargon gets started), as in the first balloon. Nearly all the volume is encompassed by the pink lines, but there is a heavier concentration within the blue lines because of where price spends the greater part of its time. The volume in the balloon “B”, however, is more evenly distributed throughout the zone, partly because price spends so much time in it and partly because it ranges fairly steadily within it. Instead of rushing to the limits and bouncing back toward the center, they linger at those limits, the sellers trying to push price lower, the buyers trying to push price higher. Thus there is more volume at these edges than in balloon “A”, but buyers eventually fail in their task as sellers do in theirs, and trading drifts back toward the center, providing, again, a relatively even distribution of volume throughout the range.

Balloon “C” is similar to “A” but much thinner due to the fact that price has made only a single round trip to the bottom of the range. It lingered a bit in the middle, simultaneously creating that protrusion in the center of the volume pattern. But volume at each end is thinner than in “B”, thinnest at the bottom due to the V shape, giving the volume – if one is fanciful – something of a P shape.

If price drops through one of these zones, those who bought within that zone are going to be miffed. Some of these people are going to try to sell if and when price re-approaches that zone. This is the basis of resistance. There's just too much old trading activity to work through in order for price to progress unless there is enough buying pressure to take care of all those people who want to sell what they have, then push price even higher (in which case those who sold may think they screwed up yet again and buy back what they just sold). However, those who bought or sold at the outer reaches of these zones will also be disappointed if they can't find buyers for whatever it is they just bought, not because there's too much volume but because there isn't enough.

So how does one trade all this?

First, you will have to monitor several intervals at the same time in order to

(a) Find out what interval you want to trade and

(b) Where price is within whatever range or ranges is/are in that interval.

<u>Support & Resistance and Trading Trend</u>

Put simply, support is the price at which those who have enough money to make a difference are willing to show their support by retarding, halting, and reversing the decline by buying. Resistance is the price at which those who have enough money to make a difference attempt to retard, halt, and reverse a rise by selling. Whether one calls this money professional or big or smart or institutional or crooked or manipulative or (fill in the blank) is irrelevant. If repeated attempts to sell below this support level are met by buying which is sufficient to turn price back, these little reversals will eventually form a line, or zone. Same is the case with resistance.

A swing high or low represents a point at which traders are no longer able to find trades. Whether that point represents important support or resistance will be seen the next time traders push price in that direction. But everyone knows this point, even if they aren't following a chart. It exists independently of the trader and his lines and charts and indicators and displays. It is the point beyond which price could not go. Hence its importance, both to those who want to see price move higher and those who don't.

If one doesn't understand trend, he's going to have trouble understanding **breakouts, retracements, and reversals**. If he doesn't understand support and resistance, he's going to have trouble understanding how and where and when to enter and exit, much less where to take profits, assuming he has any.

Traders must understand the characteristics of a trend day, even if interested only in intraday scalping. A trader anticipating a trend day should change strategies, from trading off support/resistance . . . to using a breakout methodology and being flexible enough to buy strength or sell weakness. A trader caught off guard will often experience his largest losses on a trend day as he tries to sell strength or buy weakness prematurely. Because there are few intraday retracements, small losses can easily get out of hand. The worst catastrophes come from trying to average losing trades on trend days.

Raschke

To determine the effects of supply and demand, look for breaches of either support or resistance within whatever interval you're trading, particularly a breach with a quick and strong recovery (which belies the breach and suggests strong buying interest [demand] or selling interest [supply], whichever the case may be). If one is trading trend over the longer-term, he has little to do but sit on his hands until price breaks out or breaks down. If he chooses to trade the shorter-term, he can buy failures to break through support and short failures to break through resistance during those “balancing” or “equilibrium” phases.

To understand that price rises because demand -- or buying interest -- is greater than "supply" -- or selling interest -- is a no-brainer. The trick is to recognize these changes in balance or equilibrium in real time. Hindsight charts are fine for illustrating principles. In fact, they're nearly essential. However, one must then take the next step and translate those principles into a trading strategy that enables him to make decisions based on those principles in real time, e.g., "failure to breach". For example, one must at least locate in advance those areas or zones, in which the aforementioned balance is most likely to change, and then wait patiently until those changes actually occur, then act on what he observes.

The *first step* ***for a trader is to determine the current trend of the market.***

The *second step* ***is to determine one's place in the current trend.***

The *third step* ***is to determine the proper timing of one's entry into whatever it is he's trading.***

-- Richard Wyckoff

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