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From the Roar of the Pits to Candles on the Screen: Translating Floor Trading Emotion into Screen-Based Trading

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Movement in price is based simply on supply, demand and the human behavior relationship that exists in any market. And, clearly, opportunity always arises when this equation is out of balance. Whether trading the S&P, buying a house, a car or a Michael Jordan rookie card, how we make money buying and selling never changes.

My Path

Let me begin by saying that I have never read a trading book from cover to cover. Also, I started my career on the floor of the Chicago Mercantile Exchange (CME), not looking at a screen-based chart for the first year. On top of that, from an early age, I was always taught not to accept something as true just because someone says so. What I do is apply simple logic to everything that presents a challenge, and trading presents a challenge second to none.

At the CME, I could have taken a variety of classes and started reading all the books, but personally chose another means of gaining knowledge about trading the markets. I had two very good friends on the floor of the exchange. One worked for a firm, and the other traded for himself and was one of the more successful traders on the floor. I was young and ambitious and just wanted to learn how he was doing it and, fortunately, he was willing to give me advice.

As I stood next to him in the pit, he pointed out a trader across the pit and instructed, "Sam, see that guy over there? Let me know when he makes a trade." I stood and watched the man across the pit, and when he raised his hands to bid for some contracts, I alerted my friend.

Lessons from the Floor

It was loud in the pit, as prices had been moving higher for some time. My friend pointed out to me how desperately the gentleman in question wanted to buy. He stood on his tiptoes, yelling at high volume to anyone who would sell to him. Seconds after pointing out these human behavior traits to me, my friend gladly filled his order by taking the other side of his trade, and we had a short position open; little did I know that my lesson had just begun. A few minutes later, the market fell, and we had a winning position. Being new at the game, I was impressed. In fact, it seemed too easy and very hard all at the same time. We had just profited from a position in minutes, which made it appear easy. The entry, however, came on the short side when it seemed everyone else wanted to buy in a very bad way, and this didn't make much sense at the time.

My friend explained, "That guy is somewhat new in the trading pits and consistently loses. Turns in the market happen when the novice trader has entered the market; therefore, all I have to do is find the novice trader and take the other side of his trade consistently."

I could not believe that this was how my friend had become so successful. There had to be more to his strategy! But, indeed, this was the essence of his trading approach, and he had little else to tell me. He did, however, give me a knowing smile at the end of the day. What was conveyed was something much more powerful than I realized at the time.

He was right. That novice trader was making his decision to buy based on emotion, not objective information. Had he looked at objective information, he would have seen that he was buying after a period of buying (late and high risk), into resistance (supply) (low odds), and in the context of a market whose average price was falling (downtrend) (very low odds). In essence, he was entering a position when the odds were completely stacked against him. A profitable trader would never do that; the laws of supply and demand say you can't consistently profit while entering positions when the objective odds are stacked against you.

For humans in general, it is emotion that drives behavior, not intellect. Traders who make trading decisions based on emotion versus objective information are facing high-odds/low-risk trading situations.

Others' Mistakes Allowed Me to Profit

In profiling this type of floor trader, two mistakes come to light. First, they buy after a period of buying and sell after a period of selling, which is late and high risk. Second, they buy into areas of resistance (supply) and sell into areas of support (demand), which always is a low-odds trade. The laws of supply and demand and how one makes money buying and selling indicate that the odds are completely stacked against the trader who trades this way. Consistently finding this type of trader entering the markets would tip the odds in my favor.

The laws and principles of supply and demand, of course, have been around much longer than the markets themselves, and they apply to much more than just trading strategies. I was learning the core concepts of markets and how and why prices move and turn. All that was required was to first understand exactly how money is made trading anything. Additionally, it was about learning how to properly analyze the supply/demand and human behavior relationship (emotion) in any market at any time.

Further, it's important to notice that the focus is on the loser – what the majority of losers do wrong over and over again. The approach of discovering how to do things wrong in an effort to learn how to do something right has some impressive results. It worked for Plato and Aristotle, so why not apply it to trading?

Somebody Has to Pay More Than You

The only way we can make money buying something is if someone buys what we have at a higher price. For shorting, it's the other way around. Sound simple? Think again. When we view a trading floor, a screen-based chart, or the account statements of tens of millions of investors, we quickly see that the actions of the majority of traders and investors are completely backwards on this concept.

On a trading floor, the person taking the other side of a trade is right in front of other floor traders. Seeing emotion and knowing things about that individual are tools that help stack the odds in favor of those who recognize what to look for.

But What about Finding Clues on a Screen?

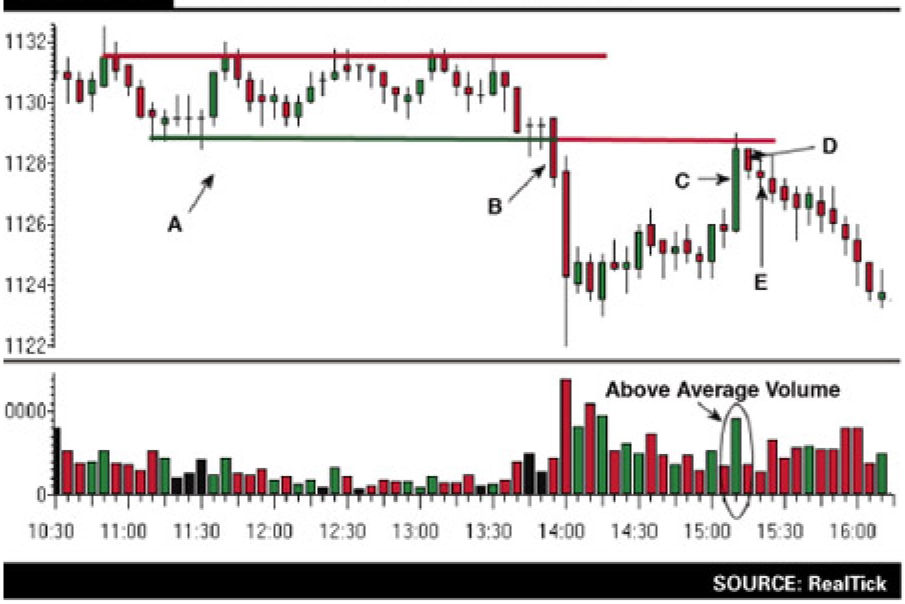
In time, much preferring the comforts of my own home and a computer screen, I realized that the trading floor was not for me. The only question was, how does one read the markets if it’s not possible to actually see and hear the people trading? How can the emotion be witnessed? After all, it seemed that valuable information comes with physicality.

When I first looked at a chart, I knew exactly what I should be looking for – as mentioned before, the trader who consistently makes the two mistakes. Though at first I didn’t know quite what this would look like on a price chart, I did know the exact information I was seeking. One need not look past candlesticks and volume in their quest to identify an emotional opportunity in the markets in the form of a supply and demand imbalance.

Candles Reveal Buyers and Sellers

It became time for me to begin translating human emotion on the trading floor to the computer screen. I chose Japanese candlesticks, as they make it easy to see which group – buyers or sellers – is controlling the market and, also, which group is about to lose or regain control. Candlesticks represent traders’ beliefs and expectations and hold the true objective information traders need when trading. That is why they are so effective.

CHART 1 Intraday Candle Chart with Volume



Let’s take an objective look at the Chart 1. This intraday chart shows a scenario that happens each day. Area “A” represents what a trading book will call sideways trading.

Taking trading to a more professional level through objective simplicity, we will call it a price level at which supply and demand are in balance. At the close of candle “B,” we can objectively conclude that there is too much supply and not enough demand in price level “A,” and this is the only reason prices can fall. Some may wish to short this “breakdown,” but I chose to let prices fall, as entering breakouts and breakdowns is hardly ever low risk and high odds. When candle “C” forms and closes, one can objectively conclude that the majority of traders who bought on that candle are not consistently profitable. They are entering after an advance in price, though in this case, it is a minor advancement. Most important, they are entering right into an area (resistance/supply) that we already know has a supply imbalance (too much supply). They also are entering at one of the most significant reversal times of the day, and there are many of them – just look at the increase in volume.

Bringing in Lessons from the Floor

My friend from the trading floor would be glad to sell to this group of buyers as, objectively, the odds are stacked against them. The laws of supply and demand tell us that consistently profitable traders can’t consistently buy in this situation and profit over a career. When buying after a period of buying and into resistance (supply), the odds a trader will profit on a long position are very low. When we add human behavior into the equation, it is easy to see why the majority over and over is on the wrong side of the market. The short entry for this opportunity comes on candle “E,” below the low of the candle body of candle “D.” Here I identified a novice group of traders – again, with a low-risk/high-odds trading opportunity at hand.

The Task:

1) Objective anticipatory analysis: We must enter before others at the right time. In trading, we get paid when others do what we do, but after we do it.
2) Low-risk entries: Low-risk (low-stress) entries are a key to profitable trading and allow us to maximize money management strategies.

The Tools:

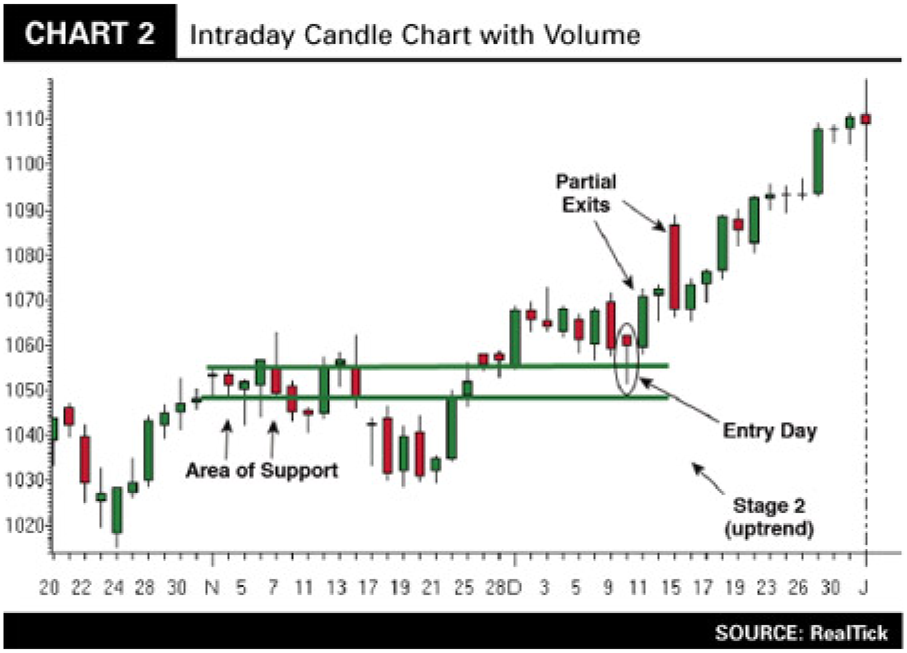
1) Candlesticks and volume
2) Proper trend analysis
3) Proper support (demand) and resistance (supply) analysis

The Analysis:

1) What is the current trend of average prices? Answering this question objectively tells us what side of the market currently carries high odds. In an uptrend (average prices rising), the odds are with the buyers. In a downtrend (average prices falling), the odds are with the sellers. Trading with the prevailing trend always carries the better odds.
2) Where is support (demand) and resistance (supply)? Answering this question objectively will lead us to our low-risk entry areas, which are always found at or near support for longs and at or near resistance for shorts. These areas are where the smart buyers and sellers enter positions. Entries in these areas carry the greatest positive odds.
3) Is there a profit zone? This is the distance from supply to demand, or vice versa, at the time of potential entry. For longs, this simply is calculated by subtracting the support area from the resistance area. The opposite is done for shorting.

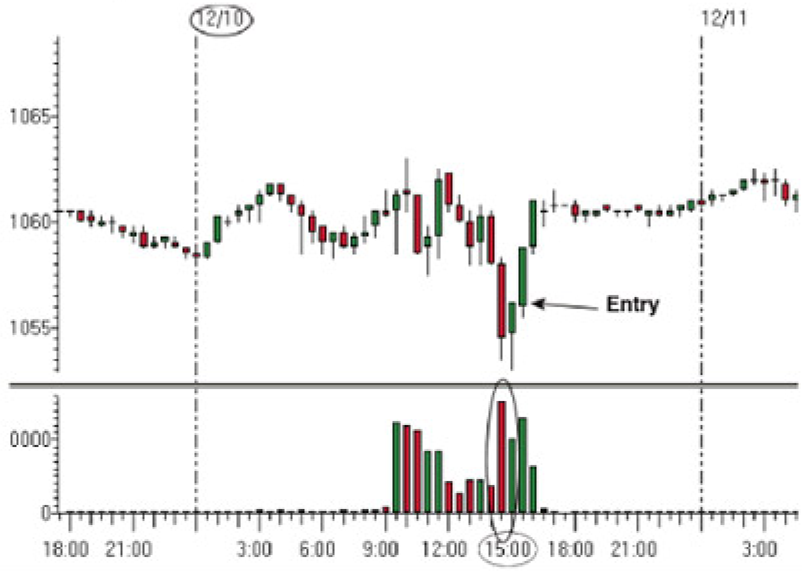
Know What to Look for

Identifying the likely turning points in price comes down to a simple and mechanical set of criteria. Let's perform an objective, anticipatory analysis while looking at a real trade in the S&P that was entered from a very profitable, low-risk, 100-percent automated trading system built around the concepts and logic mentioned in this article.



What is the trend? The data in Chart 2 illustrates that the trend of average prices is up; this means the longer-term odds are with the buyers. Where is support and resistance? The area of support (demand) is identified by looking to the left and finding the congestion of candle bodies. Resistance in the case of this entry was seen at 10 and 30 points higher, as that is where prices had been turning lower (supply). With this information, all that's required for us to take our long entry is to go to a smaller time frame and wait for novice traders to enter the market and sell.

CHART 3 30-Minute Chart, with Entry Point



SOURCE: RealTick

The 30-minute data of our entry day is shown in Chart 3. Notice the red momentum candle on above-average volume followed by a green candle. This represents heavy selling into an area we already know is support (demand) on the daily chart. This group of sellers is most likely made up of novice traders, as they are selling when the odds are completely stacked against them – emotional trading versus objective decision-making. We simply wait for the green candle to close after that novice selling and enter on the next candle. After the candle closes, we have a long position. The daily candle on our entry day is now a reversal candle with a bottom shadow. This is an invitation for others to buy after we do, which is very important. The profits for this low-risk trade were taken at 10 and 28 points higher. This is low-risk/high-odds trading.

It is easy to see this emotion on a trading floor – who is holding a winning position, and who is sitting on a losing trade. But, today, many more people trade over a computer screen and have never been nor ever will spend time on a trading floor.

Many traders' first impressions of trading will come from a book or a seminar, not real person-to-person emotional trading. It is the first impression to markets and trading that is the most hard-coded into who you are as a trader. Books teach how to trade based on chart patterns, not generally on human emotional patterns. Trading seminars teach how to use indicators and oscillators on the chart, which can lead to faulty trading, as most indicators and oscillators are very subjective. Most books discuss chart patterns and exactly how to enter them. The problem is that these patterns are based on the premise that traders need a bullish picture to buy and a bearish picture to sell. In fact, an astute trader gets interested in going long before pretty green candles appear on a chart.

However, many trading books tend to drive herd mentality, not lead it. Even conventional technical analysis at its core can be faulty when traders base decisions on pure supply and demand and human behavior.

The “Problem” with the Head-and-Shoulders Pattern

Let’s take, for example, the popular “head-and-shoulders top” pattern. The criteria for entry in this pattern is to short on a break of the neck line. First of all, if I know that many will be shorting there and I also know that the only way I can profit is if others enter after I do, it is the last place I want to short.

Furthermore, the most important question when presented with this chart pattern is: why are the shoulders and head forming? That’s simple enough; it’s called resistance, and that’s where the focus should be. This is where the low-risk/high-odds entry is, not much lower than where the majority of traders are taught to enter.

But, remember, if everyone is taught to enter (sell short) on a break of the neckline and the trader wants to join them, who is left to sell after the trader? So, a trader must strive to be a part of the “invitation” to enter, as that is low risk and high odds. I use confirmation that the masses use, that is, to confirm a decision that I already have made.

As mentioned earlier, I have never read a trading book cover to cover. Why would I want to learn how to enter and exit positions with others if the only way I can consistently profit is to enter before they do?

Also, the way to make money trading and human nature are inversely related. People, in general, are only comfortable buying if others have bought. They avoid taking risk unless others are willing to share the risk. Traders and investors tend to buy on good news and sell on bad news. Trust me, good news and nice comfortable green candles don’t bring prices down to areas of support (demand), which is where traders want to buy. Unfortunately, it usually is the bad news that tends to offer the low-risk/high-odds buying opportunities.

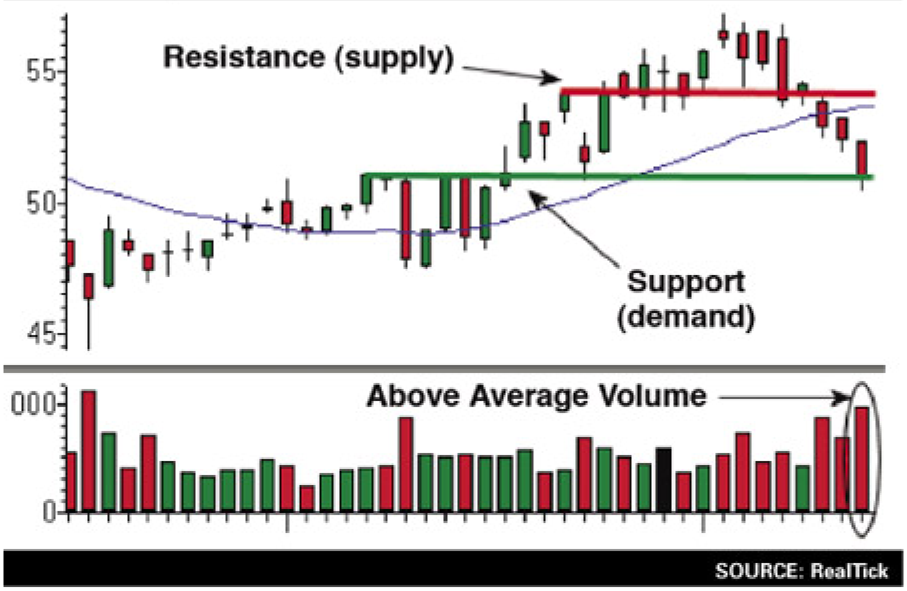
The Screen Trader’s Job

The quest in screen-based trading is to identify human patterns on a chart and then apply simple logic based on the laws and principles of supply and demand. Most traders who fail tend to look at the details of each trade to figure out where they are going wrong. What they instead need to do is step out of the novice box and consider the essence of trading at its core. Instead of reading a trading book per se, a more productive approach may be to read a Psychology 101 book on human behavior, followed by an Economics 101 book on supply and demand…and then begin their trading careers.

Whether a market participant trades from a trading floor or via a computer platform, how money is made in trading never changes. Let’s review the steps, based on Chart 4.

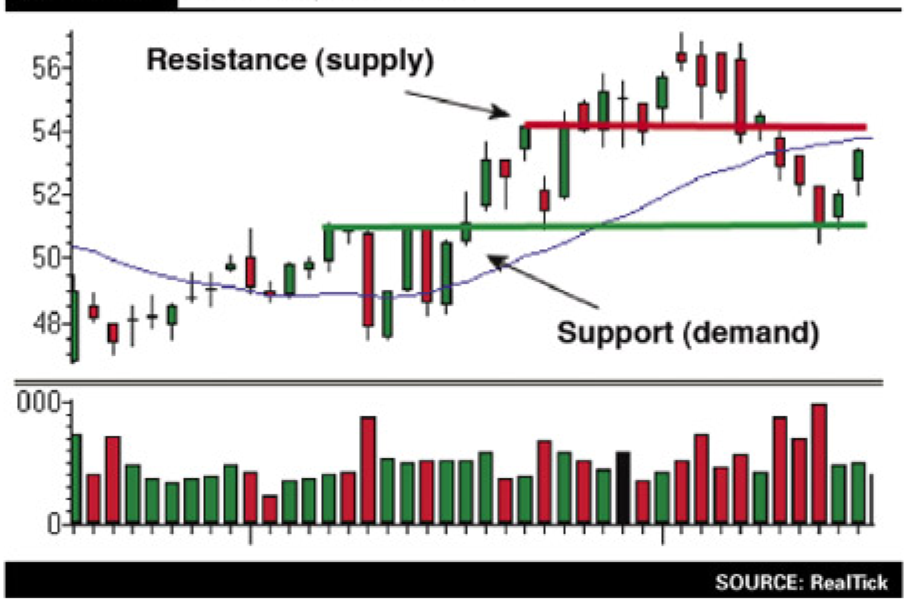
1) What is the prevailing trend? Up
2) Where is resistance? 54 (area)
3) Where is support? 51 (area)
4) Is there a profit zone? Yes, 3 points

CHART 4 A High-Odds Situation



The odds are above average as well because of the heavy volume. This illustrates that many traders are entering after a multi-candle decline into an area of support (demand), and all is within the context of a larger time frame uptrend (average prices rising). The time to enter is in this area, not after a green reversal candle. The goal is to be a part of the reversal candle which, again, tends to invite others to buy after we do. Notice how these mechanical set of criteria led to this conclusion before any sign of buying or good news.

CHART 5 Profit Target Achieved



In Chart 5, it's easy to see that this analysis paid off. Why? We became a part of the invitation to buy. Others entered the next day, and prices met the target for a low-risk/ high-odds gain.

If this information is as good as it sounds, why write about it? In my years of trading and educating, I've learned that one can spoon feed the core concepts of trading to people and, yet, most will not be able to apply the simple concepts. Why? The power of human emotions that drive our decisions are too strong. Having been in both floor-trading and screen-trading environments for years, the advantage is now largely with the screen-based trader…as long as they know what information they are looking for on a chart.

All one needs are candles, volume and some electricity for the computer.

— *end*