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Clear the Smokescreens: Take a Look At Your Trading "Belief System"
by: Sam Seiden

Trading psychology is a subject most books and so-called professionals keep separate from the mechanics and strategies of trading and investing. But perhaps this is a mistake. Many in the trading community misunderstand a key connection—simply that the underlying mechanics and strategies within trading and investing are a direct function of one's personal psychological belief system.

Information Overload

Let's take a look at how this can occur. At any given time in the stock market, there are buy and sell invitations sent out in the form of news events, technical indicators, earnings reports, company announcements, brokerage upgrades and downgrades, and much more. These invitations are then received by the belief systems of tens of millions of traders and investors worldwide.

What separates the consistently profitable market player from everyone else is a psychological belief system that filters all these invitations to buy and sell through the market's ongoing supply (resistance) and demand (support) relationship. When this filtering process is done properly, a trader will quickly realize, for example, that often a buy recommendation from a brokerage firm and/or a good earnings report from a company does not equate to market demand or higher prices for the company's stock. Conversely, negative news or a brokerage downgrade may actually be a low-risk/high-reward buying opportunity. Some of the most common and popular invitations to buy and sell occur with stocks.

In this article, I will focus on the various buy and sell invitations for stocks. More important, I will demonstrate how to mechanically filter these invitations through the stock markets true supply and demand equation. Finally, I will provide rule-based tools to take advantage of these frequent red flags and opportunities.

The Goal

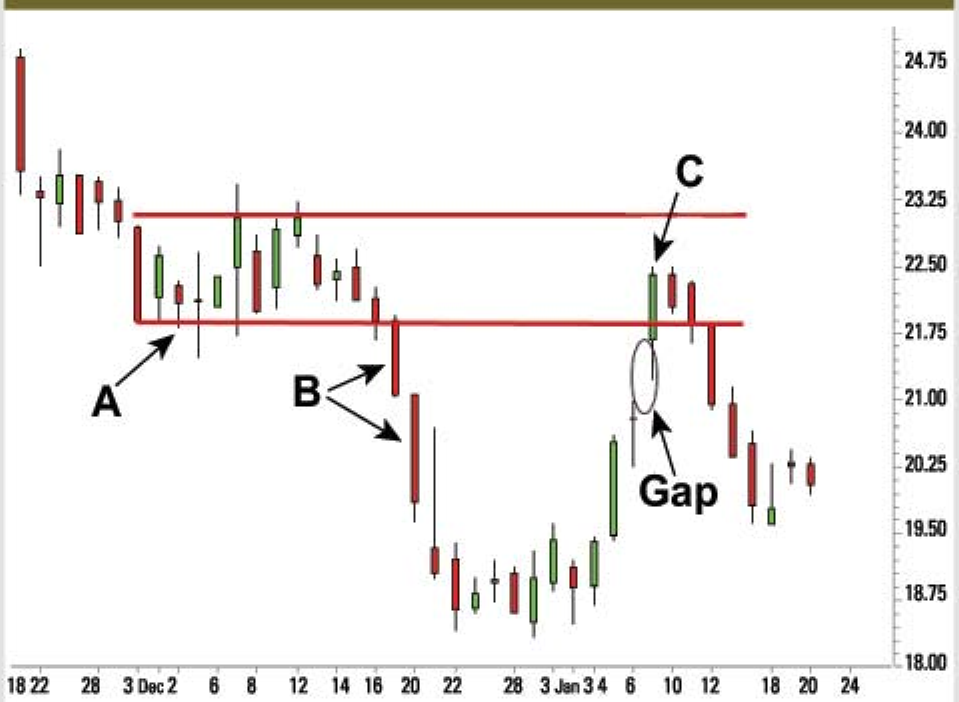
A psychological belief system that enjoys consistent low-risk/high-reward profits is one that identifies and accepts an invitation to buy into a market when the market price reflects that demand but greatly exceeds supply. Traders who suffer from consistently poor results could be buying (or selling) in a market based on various "invitations," such as news events. Their lack of profitability could stem from the fact that they are buying when objective chart analysis actually reveals that supply exceeds demand (or vice versa for a sell).

Let’s take a look at the two types of buy and sell invitations. The first are the market’s buy and sell invitations, which are based only on the irrefutable governing dynamics of supply and demand. The second includes everything from good and bad news to positive and negative earnings reports to brokerage upgrades and downgrades, and many more. The first type of invitation has you focus on reality, while the second has you focus on everything but reality.

Develop A Filtering Process

For example, General Motors stock has been in the news often over the past eight months or so (see Figure 1). Candle “C” represents January 9, 2006. That morning Goldman Sachs, one of the largest brokerage firms in the world, upgraded General Motors. The moment this brokerage upgrade was delivered to your belief system through your television screen or the news feed on your computer, you could have asked yourself two questions. First: What are the so-called professionals suggesting I do? In this case, whatever the details of the upgrade are, an upgrade pushes the positive button in your brain and most people will be inclined to buy. Looking at the price action on January 9 “C”, we see this was the case as price gapped higher on the open and closed near the high of the day.

FIGURE 1: Daily General Motors Chart



Source: RushTrade Securities Inc.

Second question: What would a consistently profitable buyer and seller of anything do at this price, based on the irrefutable laws of supply and demand? When we objectively assess where current price is in relation to the market's supply and demand equation on the day of the upgrade, the invitation sent to the reality-based belief system is to do nothing or to sell rather than buy. Why? Area "A" represents a period of time when supply and demand for GM shares appeared to be in balance. Price was stable, and for every buyer there was a seller. As the drop in price at "B" occurs, the prior statement is no longer true. We now know objectively that there is much more supply than demand at price level "A". The only thing that can cause the drop in price is if there are more sellers than buyers at price level "A." Therefore, at "C," we know two things: The buyers are buying after a significant advance in price, and they are buying at a price level at which more supply than demand is present. Consistently profitable buyers and sellers of anything would never make these two mistakes. If they did, they would not be consistently profitable. The laws of supply and demand ensure that the buyer who buys when supply exceeds demand and after a period of buying will consistently lose his capital.

Sift Through the Illusions

Had you taken the brokerage upgrade as an invitation to buy on January 9, you would have let illusion tease the reality that is always right in front of you, and losses or draw down to your hard-earned capital would have followed. Had you filtered that invitation through the laws of supply and demand, you would have done nothing or sold on January 9. Why would someone make such an obvious mistake? Simply, the belief system that drives his behavior/action is flawed. When you understand that your psychological belief system is your trading and/or investing strategy, you will realize how important it is to align your belief system with reality. You are essentially searching for truth—so beware of illusion! Often, the focus of poor trading and investing results is a lack of discipline in following a strategy. But it is not a lack of discipline that keeps people from following rules; it is the fact that their invitations to buy and sell are not in line with their psychological belief systems. Thus they are conflicted when it is time to take action.

Don't punish yourself for not acting when the market calls you to action. Instead, take a step out of the box that is your belief system and make sure it is only filled with objective information and reality.

Price Says It All

Let's walk through the steps of this process. See Figure 2. First, all news and market information is filtered through your belief system. Your belief system is responsible for the thoughts and perceptions created from the news and information. From there, every thought and perception leads to action, and in trading and investing, that action is either buying and/or selling. Therefore, all the consistently profitable trader or investor needs to focus on is price. Whatever the news and information on a stock, your belief system must filter that information to determine the market's true supply and demand relationship before you take action. This will ensure that you don't fall into the trap that the buyers of GM shares did on January 9. It will also allow you to profit by trading against those who consistently fall into that trap.

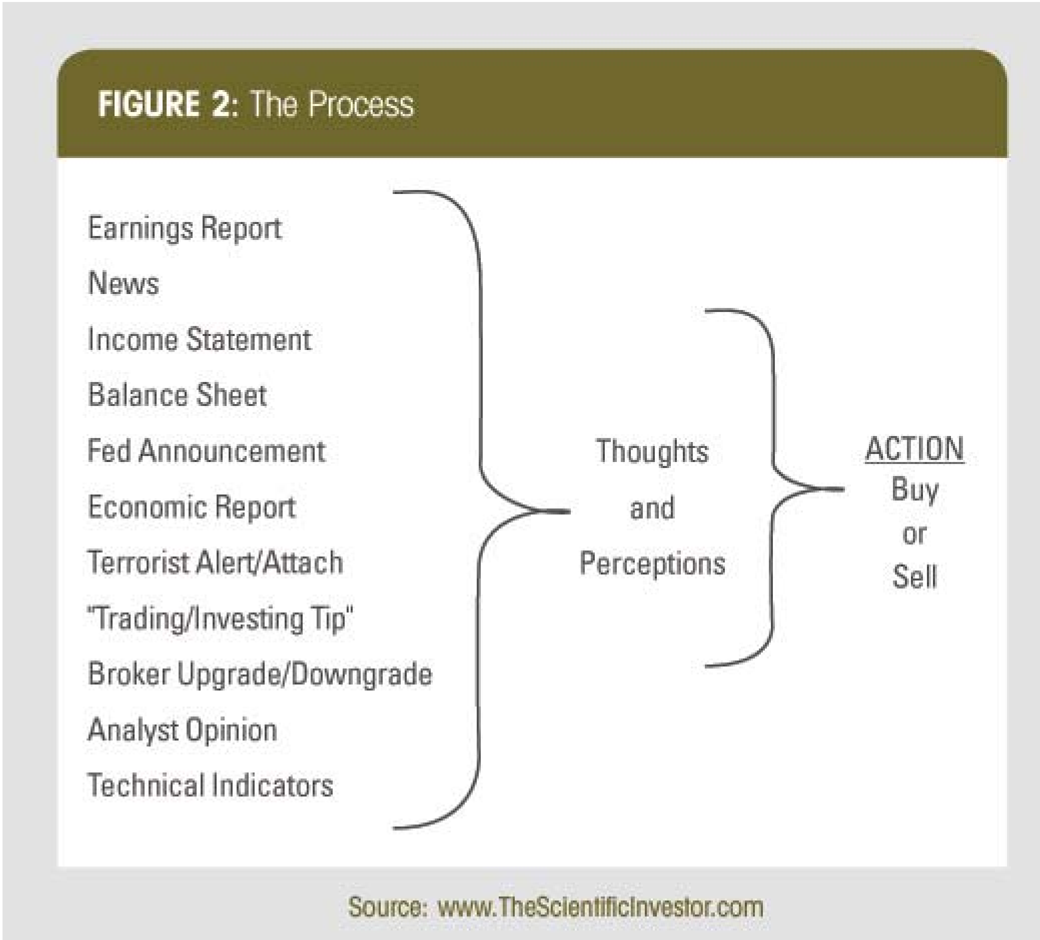


FIGURE 2: The Process

Source: www.TheScientificInvestor.com

The next step is to learn what true supply and demand look like on a price chart. If one isn't careful, illusion can creep into the equation again. Think the conventional technical analysis definitions of support and resistance are the answer? Think again! A cluster of trading activity above and below current price is not necessarily true supply and demand. There is a unique and simple chart pattern that represents peak demand and peak supply. While the details of this are beyond the scope of this article, the chart examples I have provided should help guide the way. Once you are able to identify true supply and demand on a price chart, simply follow these two rules:

- A negative news event or negative stock market information, which brings price to a level of peak demand, is typically an opportunity to buy, not sell.
- A positive news event or positive stock market information, which brings price to a level of peak supply, is typically an opportunity to sell, not buy.

Buyer Beware of Good News When Price Is At Peak Supply

Let's take a look at another example. See Figure 3. Candle "D" is Monday, October 17, 2005, the day GM released the positive news headline seen in the caption. Price opened that day at $31.39, a huge gap of $3.41 from the prior Friday close of $27.98. While the news was very real, it equated to instant losses for those who bought based on that news the morning it was released. How can real positive news for the company equate to such a severe drop in price for the stock? Simple — price reached a level at which supply exceeded demand, price level “A.” We know supply exceeds demand at “A” because of the decline beginning at “B.” “D” is the first time price advances back to the supply level. Again, we can now say that the buyers at “D” are buying after an advance in price and at a price level where supply exceeds demand.

FIGURE 3: Daily General Motors Chart

Monday, October 17, 2005: General Motors Corp. said it reached a tentative agreement with the United Auto Workers that will help lower healthcare costs for GM.

Source: RushTrade Securities Inc.

Had you taken the GM news as an invitation to buy on Monday, October 17, as so many did, you would have let illusion again tease the reality that was right in front of you and lost your hard-earned capital. Had you filtered that invitation to buy through the laws of supply and demand, you would have done nothing or recognized the opportunity to sell short on October 17. To be blunt, over time, the capital of those who fall for the illusion trap typically ends up in the bank accounts of those who focus on pure supply and demand in markets. The objective supply and demand relationship in markets is revealed most clearly in price and price alone.

What you perceive to be a rational decision is actually your emotions reflected by a set of behavioral patterns you probably don’t even know exist. On October 17 the buyers of GM shares had a belief system that made them think they were making a rational decision to buy. As rational as it seemed to those buyers, it certainly was not logical. Instead it was due to a faulty belief system that was not in line with reality.

Is It A Sell or a Buy?

Take a look at Figure 4. Notice the day of the major gap down in price in shares of Genzyme, a biotech stock "C." This three percent drop in price came right after the Associated Press released the negative news that an analyst at Bear Sterns had downgraded the stock. In the news report, this analyst, who has a Ph.D., gives his reasons for the downgrade. However, for those with a Ph.D in reality, it was clear that price had gapped down right into a price level where demand exceeded supply (price level "A"). Again, we know this to be true because the advance in price "B" from price level "A" could only happen if there were more demand than supply at "A." In other words, prices gapped down to a price level where there were more willing buyers than sellers. Any time that happens, price must rise. While the news was negative and the masses were invited to sell on the downgrade, the reality-based trader or investor was offered a very low-risk/ high-reward buying opportunity.

FIGURE 4: Daily Genzyme Chart

Source: RushTrade Securities Inc.

Monday, November 7, 12:59 pm ET

AP: Genzyme Shares Drop on Analyst Downgrade

NEW YORK (AP) — Genzyme Corp. shares slumped about three percent Monday after a Bear Stearns analyst said that Medicare changes will cut reimbursement for the biotech firm's joint-lubricating treatment by more than 40 percent next year, removing an advantage it had over certain competing products. - AP

An analyst at Bear Stearns noted in a report downgrading the stock that Medicare will start reimbursing all joint injections made from a substance called hyaluronan at the same rate in 2006. - AP

Supply and Demand Are the Keys

The natural invitation to buy is inversely related to how you make money buying and selling anything. It is certainly not in alignment with supply and demand. However, most people are not naturally invited to buy when the objective low risk/high reward buying opportunity is in front of their face. As you can see in Figure 4, price must decline in order for it to reach an objective peak demand level. The vast majority of people are only comfortable buying after a period of rising prices, not declining prices. Also, most people are not comfortable buying when the news is bad.

What challenges your natural human emotion most is the fact that pretty green candles [rally days] and good news rarely, if ever, bring price down to levels where demand exceeds supply. This is all quite ironic if you think about it because if you take your average trader or investor out of the market environment, he or she acts almost opposite when buying and selling anything else.

For example, when we buy a car, we try to get the best deal we can. The astute car shopper finds a car and knows what price he or she is willing to pay and attempts to get that price. If that dealership is not willing to drop the price to the buyer’s desired price, that potential buyer typically goes from dealership to dealership to find someone willing to sell the car at the lower price. In trading and investing, however, people for some reason wait for good news and higher prices before deciding to buy, and this makes absolutely no logical sense if your goal is to buy low and sell at a higher price. It is completely inversely related to how we profit when buying and selling anything.

Whether you trade or invest in stocks, bonds, futures, currencies, options or anything else, how you profit in these markets and how you quantify supply and demand never changes. Furthermore, a trading and investing strategy that works is one that is not market specific or time-period specific. Traders who seek to develop a strategy that offers consistent low-risk returns need to develop a mechanical filter that can sift through the vast amount of news and information—or “illusion”—bombarding market participants. Traders need to focus on a method that objectively quantifies peak supply and demand and that can work in any market, in any timeframe. Don’t let the shadow of illusion darken the reality of a governing dynamic that is always right in front of you.

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