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Trade What is Real, Not What You Feel

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Achieving consistently low-risk profits from trading and investing is a challenge millions of people actively embrace, yet only a select few are ever able to master it. The objective and mechanical rules for these consistent profits are very simple, yet layers of illusions keep most people from ever seeing what is real in trading and investing.

These illusions are found in the two main forms of analysis, conventional technical and fundamental analysis. While these analyses are indeed very real, the dream that conquering them ultimately will lead to consistent profitability is an illusion second to none. The more an individual attempts to master these types of analyses, the more they may be layering subjective complex illusions on top of one other. This is a recipe for consistent failure.

What many beginning traders do not realize is that they are walking east and west trying to reach the North Pole. Mastering technical and fundamental analysis, if it is even possible, seems to be the magic formula for consistent, low-risk profits, but that may merely be an illusion. The more individuals attempt to conquer the “secrets” behind each of these analyses, the more they may be layering subjective complex illusions on top of one other.

The focus of this article is to identify and remove the veil of illusion from trading and investing and to help market participants decrease risk and increase profit potential by understanding the difference between reality and illusion. How? – by realizing that the movement of price in any market is based at its core on an ongoing supply/demand and human behavior relationship. Thus, in this article we quantify this supply/demand imbalance for objective opportunity.

Beliefs and Behavior Patterns = Actions
Let’s move backward one step at a time. Clearly, our actions stem from behavioral patterns, and behavioral patterns stem from our beliefs. It is at the level of beliefs that decisions are made; moreover, it is where our ability to differentiate reality from illusion lies.

The strongest illusions in the trading and investing world are found at the core of fundamental and technical analysis. In this piece, we focus on three of those major illusions.

Moving Averages
The Illusion: Figure 1 is a daily chart of the S&P 500. The information most people will perceive from this chart is an illusion that likely will lead to high-risk/low-reward trading and

investing. The illusion here is that moving averages (MA) somehow act as support or resistance. There are many conventional ways for traders to use moving averages. These include using moving average crosses for entries and exits, measuring the slope of a MA for a "trend filter," or using a MA as support or resistance. However, the notion that MAs actually offer a benefit when used in these conventional ways is completely false.

FIGURE 1: Daily S&P Chart, with Moving Averages

Source: TradeStation

Figure 1 shows a 20- and 200-period moving average. These are widely used moving averages in the trading and investing communities. Notice the slope of the 20-period MA at the areas labeled B. The slope of the 20-period moving average is down in both cases, suggesting a downtrend is underway. During this period however, the low-risk/high-reward buying opportunity is greatest and right in front of you!

Those who use a MA as a trend filter would never buy when the trend is "down." An illusion-based trader and investor likely would conclude, "I don't want to buy now because the MA tells me this is a downtrend." The illusion created by using a MA to determine trend ensures market participants will ignore the lowest-risk/highest-reward opportunity each time it is offered. Furthermore, this illusion is likely to encourage a trader to take the opposite action of what the objective information (reality) suggests he or she should do.

Moving Averages Lag

MAs, of course, are averages of past data. They can only turn higher after price does. Let's focus on the 200-day moving average. Specifically, notice the area B that is below the 200-day MA in Figure 1. Most traders and investors see either the 200-day MA on a chart or hear about it from some financial news TV program. They perceive the mighty 200-day MA as some magical line that, when crossed, suggests some valuable information.

Actually, waiting for prices to rise above the 200-day MA before buying ensures three things. First, risk to buy is high, as one would be buying far from the supply/demand imbalance. Second, profit potential is decreased. Third, those who wait until prices have crossed back above the 200-day MA to buy likely will provide profit for the reality-based trader/investor who bought at B, the low-risk/high-reward entry area. The objective supply/demand imbalance is at

B, and the 200-day MA has nothing to do with it. When a moving average lines up with true demand or supply, the moving average will appear to work. Believing that the moving average actually has anything to do with a turn in price is an illusion.

The Reality: Let's now explore reality through the eyes of objective logic. The areas labeled A in Figure 1 are objective demand (support) price levels. How can I claim they are objective demand price levels? Simple. When prices are trading sideways, supply and demand are in balance. In both instances, prices rose dramatically from those areas of balance. The only thing that can cause a price rally from an area of "balance" is when the supply and demand equation becomes "out of balance." In other words, there were many more willing and able buyers at A than there were sellers. The laws of supply and demand simply tell us this is true.

The areas labeled B represent the first time prices revisit these two areas of "imbalance." In other words, prices have declined to an area where we objectively know there are more willing buyers than sellers. B is the low-risk/high-reward opportunity to buy. Buying in these two areas ensures three important musts in trading and investing. First, one's protective stop must be as small as it can be, which offers a trader proper risk-management/position sizing.

Second, one's profit potential, which is the distance from the entry to the supply area above, is as large as it will ever be for this opportunity. In other words, as price moves higher from the objective demand level, it is moving closer to the supply level (target) above, thus decreasing profit potential. Third, the probability of success is highest because supply and demand are out of balance.

The Lesson: Indicators and oscillators are nothing more than a derivative of price and volume. Price is all that needs to be considered when performing objective, reality-based analysis.

The News

The Illusion: The news illusion is perhaps the most powerful illusion in trading and investing as strong news leads to strong emotion (faulty beliefs). Most successful traders and investors at some point in their journey have fallen prey to this illusion. How many times have all of us seen bad news turn into a positive day for the markets? Area B on Figure 2 represents the day of the London bombings earlier this year. The thought of a major terrorist attack in London led many to believe that prices would fall; consequently, that belief drove the majority to sell. However, once the last seller sells at a price level where there are more willing buyers than sellers, the laws of supply and demand tell us that prices rise.

The Reality: Area A on Figure 2 is an objective demand price level as the origin of the supply/demand imbalance is at the point in which prices move higher from area A. The news of the London bombings was very real and quite shocking, and prices fell. However, once price reached area A, where objectively there was more demand than supply, they turned higher.

FIGURE 2: Daily Nasdaq Chart

Source: TradeStation

The Lesson: No matter how bad the news is, when the last seller sells at a price level where there are more willing buyers, prices rise. There can be no other mathematical outcome. Strong news actually creates powerful turns in the market, opposite of what the majority expects because one side (buyers or sellers) exhausts itself into a price level where an objective supply or demand imbalance exists.

Fundamental Analysis

The Illusion: In some cases, such as in Figure 3 (showing popular technology stock QLGC), there are a number of illusions at work at once that severely cloud reality. The rally in price for QLGC as the stock revisits the area of imbalance is accompanied by good news on earnings. An "uptrend" in price is seen, which is accompanied by a number of brokerage upgrades (source: Yahoo! Finance). The illusions here are many and create strong beliefs. These beliefs lead to action (buy or sell), and this action (buying and selling) is all we need to be concerned with. No matter who is telling us to buy the stock and why, all we need to know is whether prices are at a level where objectively there is more demand than supply. If not, there is no reason to buy.

Not only is the answer no at the time of the brokerage upgrades in Figure 3, but the laws of supply and demand tell us we should be selling here, not buying. These upgrades, which invite the masses to buy, are given right into an objective supply area where we know there are more willing sellers than buyers. The eventual drop in price from this level is fast and strong for one simple reason. The number of willing buyers at this price level became zero while the number of willing sellers was still significant (supply/demand imbalance).

All this information was available to us months prior to the rally. But most market participants didn't see it, as the illusions were strong both in substance and number. Adding to the illusion was the uptrend, and the higher prices advanced along with a greater number of people who desired to buy into it.

Face it: We are humans, and we believe there is comfort and safety in numbers. Again, many illusions come into play in this example. The illusion-based trader saw a high-risk/low-reward buying opportunity, while at the same time the reality-based trader saw a low-risk/high-reward shorting opportunity.

The Reality: The objective supply (resistance) area is labeled as such on Figure 3 because it is a price level where supply and demand is out of balance. Put simply, there is too much supply. Again, prices can only drop from that area because there are more willing and able sellers than buyers – there can be no other reason for the decline in price. Objectively, the worst possible action to take is to buy anywhere near this supply area, especially on the first rally into it. Many illusions, however, invite the masses to buy at the absolute worst time.

FIGURE 3: Weekly Chart of GLGC

Source: TradeStation

The Lesson: When risk is perceived as being lowest, actual risk often is highest, and the other way around.

Act Like a Goose

The human mind is not wired to trade properly. Our decision-making process is not like most other animals' mental processes. Most people don't focus entirely on reality when deciding to take action; we make decisions based on emotion, not intellect, and consistently making actions based on reality is a hard task.

Animals with less intellect than humans react differently. When autumn approaches in the northern hemisphere, geese don't speculate on whether winter will come or not. They simply fly south for the winter and repeat this process each and every year flawlessly throughout their lives, without questioning their choice. There is no emotion involved.

The Three Laws of Price Movement

I have been involved with trading and investing for north of a decade, and the consistent low-risk profits I have produced are a function of trading what is real, not what I feel. Eliminating subjective emotions by basing each and every decision on a simple mechanical set of objective rules that quantify supply and demand is part of my credo. These simple rules, which are beyond the scope of this article, stem from three laws of price movement crafted long ago. These three laws form the foundation upon which the whole system of proper trading and investing lie.

Laws of Price Movement:

1) Price movement in any free market is a function of an ongoing supply and demand relationship within that market;
2) Any and all influences on price are reflected in price;
3) The origin of motion/change in price is an equation where one of two competing forces (buyers and sellers) becomes zero at a specific price.

A successful trader's path must be reality based, not driven by illusion. The reality is that markets are nothing more than pure supply and demand at work – human beings reacting to the ongoing supply/demand relationship within a given market. This alone, ultimately determines price. Opportunity emerges when this simple and straightforward relationship is out of balance. When we view the markets for what they really are – looking at them from the perspective of an ongoing supply/demand relationship – identifying sound trading and investment opportunities is not that difficult of a task.

[Editor's Note: For more detailed information on Seiden's supply/demand concepts, see "Focus on True Supply and Demand...and Better Your Odds for Low Risk Entries" in the November 2004 issue of SFO.]

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