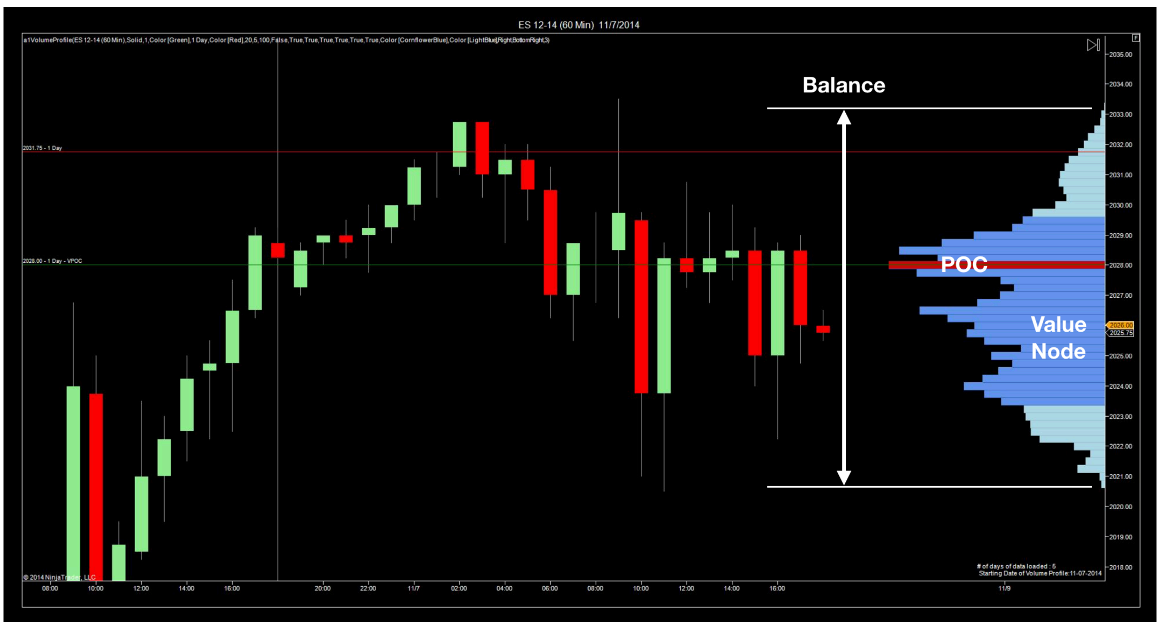
VOLUME PROFILE &

Volumetric Market Analysis



Ernie Varitimos

TABLE OF

CONTENTS

INTRODUCTION

VOLUME PROFILE

This book is primarily about Volume Profile, a charting tool for visualizing volume at specific price levels. But it is much more than that. It is a comprehensive methodology for analyzing markets, by employing a wide range of volume centric methods, as well as price patterns and fundamental analysis. This book will combine the works of people like Richard D. Wyckoff, Humphrey B. Neill, Tom Williams, and Thomas Bulkowski, all pioneers in their respective disciplines.

A Volume Profile is a way to visualize the amount of volume traded at a specific price level. Why is this so important to a trader? Because it reveals the amount of market interest or demand, or lack thereof, in the asset you are analyzing to trade. The amount of volume traded at price levels affects the movement or behavior of price, because there are existing transactions that must be dealt with before moving on.

The market decides at which levels of price there is value, and which levels of price it finds little or no value. If it finds value in a particular price level, the market tends to gravitate towards that level, hang out there and auction back and forth to come to some resolution. If the market thinks there is little value at a price level, it tends to reject that level and either reverse its direction, or move through that level very quickly, like running barefoot over hot coals.

This behavior is the fundamental and principle tenet of our analysis, it is what we use to fashion trade strategies and setups. Secondary tenets include the bullish/bearish bias we develop from fundamental analysis of the markets and/or assets we are trading, and chart patterns that have statistical significance. Statistical significance generally means there is two thirds (67%), or better probability of occurrence.

VOLUMETRIC MARKET ANALYSIS IN A NUTSHELL

Let’s call it VMA for short. I will refer to it that way from now on, both in this book as well as in all my social mediums, like YouTube, Twitter and Discord.

VMA is a comprehensive way of analyzing where the market is likely to go. In order to do this, we need to understand and develop a fundamental narrative view of the market, and from that a bias. That bias can be both dynamic or conditional, or it can be static, where we simply gauge the amount of bullishness or bearishness there is in the market.

We then use that narrative outlook, that bias as an overlay to our Volume Profile analysis, which reveals a multidimensional market structure, that defines the potential behavior of price movement. From this we can establish high probability entries and comprehensive trade management strategies.

In other words, we will be able to plot out different scenarios of where price is likely to go, and assign relative probabilities for each of those scenarios, and then trade those scenarios accordingly, using sound risk practices. These sound risk practices will be guided by a set of principles or tenets, and an overriding philosophy.

HILLS AND VALLEYS

A volume profile looks like hills and valleys rotated 90 degrees. The hills are higher volumes at price levels and the valleys are lower volumes. Other names that I will refer to the hills include nodes or high-volume, or high-value nodes (HVN), another name you'll see is balance or POC, which stands for point of control. The valleys are generally referred to as low volume wells (LVW), or just wells. We will discuss these terms in the chapter on the anatomy of a volume profile.

High volume nodes are associated with high participation from the market, but less overall movement, so volatility is generally lower, which we can measure as a lower average true range. Price tends to move more slowly, like in a thick soup.

These high-volume nodes are of particular importance to traders because price tends to gravitate towards a high node or POC, and so these levels can often be considered targets for trades. Areas of higher liquidity are much easier to take profits from.

Low volume wells are generally associated with much higher volatility, and a bigger average true range of price. Price tends to move quickly through these areas because the market, for whatever reason, does not find any significant value, and so it wants to search out that value, and with low liquidity it is easily manipulated or pushed towards other levels.

These low volume wells are particularly important to traders, because the lowest part of the well usually defines a price level that represents support or resistance, depending if price is above or below, respectively.

HISTORY OF VOLUME

While we feel volume with respect to price (Volume Profile) is the most accurate way to gauge market participation, price action, and supply and demand, we also believe that having a solid foundation in price with respect to time is very important as well.

What we’re talking about is analyzing the volume indicator that most traders include in their charts at the bottom, but few actually use as a regular part of their analysis.

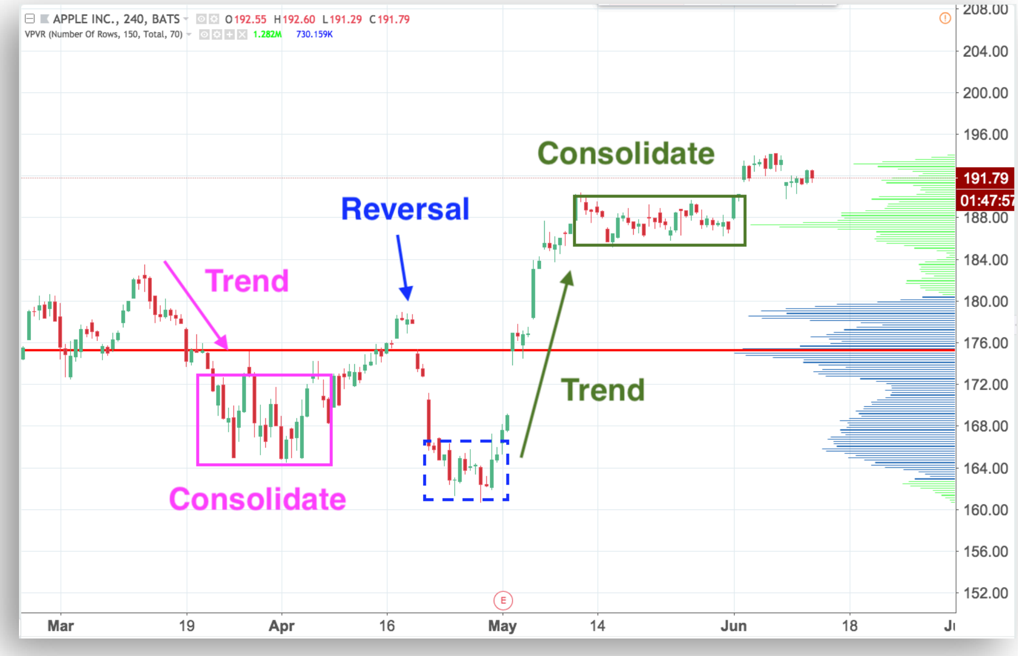
I call this volume history, because that’s exactly what it is, the volume that has occurred over time. This is in contrast to volume profile, which is analyzed with respect to the present moment in time. A powerful distinction.

When you analyze volume with respect to time, you are doing so in conjunction with chart patterns, like periods of consolidation (flags, wedges and triangle formations), or reversals in price, or continuations of a move. This type of volumetric analysis is largely thought of as confirmation of the chart pattern.

When you use Volume with respect to time, it will add a powerful dimension to your overall analytical capabilities. And to get you started, there are three volumetric principles that you should know, that correspond to the three primary ways that price moves; consolidations, reversals and trends. But first, let’s look at how markets move and then apply these principles.

HOW MARKETS MOVE

Markets tend to move in one of three primary ways, either price action is consolidating or moving sideways, or it is trending, or price deices to stop the current trend and reverse direction. And we can see these primary behaviors in every timeframe, from weekly and daily charts, right down to hourly, 15 minute or 5 minute, or even tick charts.



It is interesting to note that, in general, price is either trending or consolidating, and the overall time it spends in these two modes is pretty regular across all markets, all assets and timeframes. About 70 percent of the time is spent consolidating, or moving sideways, and 30 percent of the time is spent trending, or looking for a level that a market considers having value, where it will likely then consolidate, or auction…creating a balance or high-value node (HVN).

Another interesting thing to note are the primary actors involved in the different types of market movement. These actors are identified by their primary trading strategy, which is characterized by the time they spend in the market. And we have basically three types of traders, the trend traders or long timeframe traders, these tend to be the most influential actors, with the most money, capable of quickly moving markets from one area of value to another. So, in other words, these are the actors that usually get a trend going.

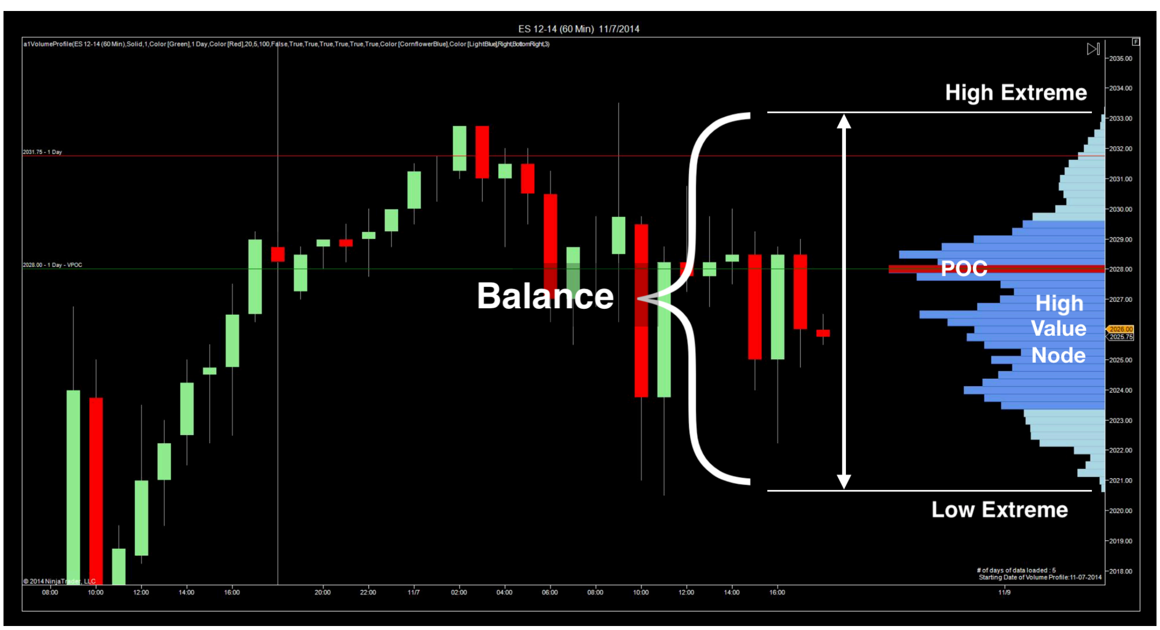
The other two actors are swing traders, or medium-term traders, and day traders and scalpers, who are short-term traders. The swing traders tend to exert slightly more influence on the market, but not by that much. Both the medium term and short-term traders participate primarily in the consolidating part of market behavior.

The reason it may be important to know who the primary actor in play is, is in the confirmation of fundamental analysis you perform.

ANATOMY OF VOLUME PROFILE

Early in this chapter the observation was made that markets are for the most part either trending or consolidating. And we noted that about 70 percent of the time markets are consolidating. The trending part often happens abruptly without warning, and often originates from the POC. Sometimes it starts from an extreme, runs through the High Value Node and the POC, to the opposite side of the balance, or opposite extreme.

Okay, so I'm using a bunch of terminology that probably seems foreign to you, and that can be confusing if you're trying to learn a new thing, so let's spend a little time examining the anatomy of a Volume Profile, identify the parts and establish a common lexicon.



High Value Node (HVN) is the area usually colored darker than the rest of the profile. It represents bout 70 percent of all the volume in the profile.

Point of Control (POC) is the highest volume bar in the profile. This is where the market has discovered the most value. Price tends to gravitate towards the POC.

The High and Low Extremes are the very top and bottom of the profile. These are the areas with the lowest amount of volume. Price tends to be rejected or pushed away from extremes. Extremes act as support and resistance. Sometimes price moves quickly through the extreme, like a breakout or start of a trend.

OTHER VOLUME CENTRIC METHODOLOGIES

Although this book is dedicated to Volume Profile, it is important to recognize that no single methodology will provide all answers, so we advocate the use of supportive methods to help fill the gaps. These volumetric principles were derived from the works of Humphrey B. Neill, a well-known trader from the 1930s, famous for two books, the Art of Contrary Thinking and Tape Reading and Market Tactics.

Okay, so let's look at how volume can be used to confirm a consolidation, reversal or trending market.

Here are the three volumetric principles:

Principle #1 `Lull in price movement after a strong push up or down, accompanied by increasing volume, a reversal is likely to follow.`

Principle #2 `after a sharp trending move if price consolidates and forms a balance, and volume declines over that consolidation, the next likely move is a continuation of the previous move.`

Principle #3 `If volume is increasing during an advance, with small pauses of lower volume, this is a sure sign that the advance will continue...and the underlying Demand is greater than the Supply.`

Additional methodologies will be recognized throughout this book dealing with volume, such as Volume Spread Analysis (VSA), which was built upon the pioneering work of Richard D. Wyckoff, a trader from the 1920s. We will cover the Wyckoff method and VSA more fully in chapter X.

VSA is from the work of Tom Williams, a successful trader from the 1960s, and the creator of the TraderGuider System. VSA takes a multidimensional approach to analyzing the market, looking at the relationship between price and spreads in volume. VSA is unique in that it is neither technical nor fundamental analysis, and is particularly useful in highlighting the imbalances of Supply and Demand, and identifying the activity of the "Smart Money."

What is Smart Money?

This is the capital controlled by institutional investors, whales, big players like Buffet, Soros, Icahn and other professionals. I like to refer to the people that Jack D. Schwager interviews in his series of books called Market Wizards. The traders and investors in these books are undoubtedly part of the Smart Money club.

SYSTEMATIC TRADING

“Trading is the hardest way to make easy money” – Greg Simmons

The opposite of systematic trading is discretionary trading. This is where you have a loose set of rules or no rules at all. You take your trades based on feel, intuition, tips, anything really. You may have a trading style that you prefer, short-term or long-term, but you are not bound by time; and you may have risk controls, but they are not applied consistently, more like when you feel enough pain.

Systematic trading, also known as mechanical trading, is closely related to quantitative or automated trading. You have well defined strategies and rules, with purposeful risk measures. And most importantly, your trade with a cadence or timebox your activities so that your methods can be measured, evaluated and controlled.

At a high-level, a systematic way of trading means that you are in a closed loop, or decision cycle. Perhaps the best-known decision cycle is the OODA loop, which stands for observe, orient, decide and act. It was originally developed by a military strategist Colonel John Boyd of the United States Air Force. It was originally applied to combat operations processes during military campaigns. And now it’s often used in commercial operations and learning processes. The approach favors agility over brute force.

Virtually all successful traders apply similar processes and concepts in their trading, because it allows them to eliminate bad habits and reinforce good ones, while constantly tracking and improving performance. What we will introduce here is a framework called the Trading Campaign, that borrows many of the concepts from OODA as well as Agile development processes.

TRADING CAMPAIGNS

A trading campaign is a timeboxed loop of strategies, processes and a retrospective that is designed to put a light-weight structure, discipline, and continuous improvement around a very complex activity. If you can master the campaign, your profit & loss and ability to build wealth will directly reflect that mastery.

The campaign includes three processes and two important ceremonies. And the campaign has a definitive beginning and end, where subsequent campaigns use the output of the retrospective ceremony as input to the initiation ceremony. The three processes include Develop Strategies, Test Strategies, and Deploy Strategies.

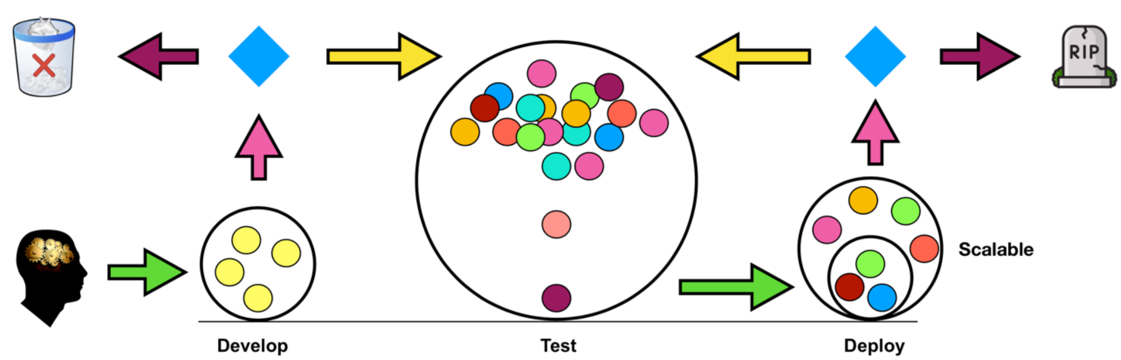
There are three primary tenets; 1) trade multiple non-correlated strategies, 2) trade so small that no deployed strategies will cause you to lose sleep, and 3) always put capital preservation first, and profits second.

Multiple Non-Correlated Strategies

This is the holy grail of trading. Non-correlated means that the returns are statistically different, primarily because the strategies use different and unrelated methods for determining entries and exits and may also be executed in different timeframes. There are limits to how many strategies that can be reasonably managed, usually determined by the amount of available capital, but also the minimal number is usually governed by cost of doing business. Let's just say that you should have at least 2 or more strategies to deploy, there's no specific limit to the total number you deploy, but generally the more the better.

Multiple non-correlated strategies have the effect of a natural hedge.

No single strategy can be relied upon in all conditions and indefinitely…if you find such a strategy, please let me know. So as such, we must have multiple strategies that can perform over a wide range of market conditions, producing a kind of anti-fragile effect.



Trading campaign

CEREMONIES

Every trading campaign starts off with the Initiation ceremony, where you define the purpose or objective, allocate a certain amount of capital to put to work, determine the length, or timeframe of the campaign, and ready some strategies to deploy. These decisions, along with any rules, adjustments, or edicts carried over from a previous campaign, are used to initiate the campaign.

When the campaign is nearing the end of the timeframe, the second ceremony if conducted, and this is called the Retrospective. This is where we determine if the objectives were met, how well we did, and what adjustments should be made for subsequent campaigns.

PROCESSES

There are three main processes within the campaign, and they run in parallel with each other. The majority of time is spent developing and testing new strategies. The rest of the time is spent managing positions in the deployed strategies.

A campaign can be scaled vertically and/or horizontally by increasing the position size allocated to strategies and/or increasing the number of deployed strategies.

COLLECTING & ANALYZING DATA

The single most important activity that occurs across all the processes and ceremonies is the collection and analyzing of data. The reason we have structure and rules is so that the data we collect is consistent and homogeneous so that there are baselines and statistics that can be relied upon. These statistics are the basis of proof that we are meeting our goals.