

MARKETS AND

MOMENTUM

**HOW PROFILING
GIVES TRADERS AN ADVANTAGE**

JAMES F. DALTON

WILEY

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ROBERT BEVAN DALTON**

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PREFACE

Excellence in any endeavor – whether it’s surgery, sports, or futures trading – can only be achieved by balancing the analytical and intuitive powers of your brain. Put another way, you must constantly seek to balance your conscious and your unconscious mind.

There is no finish line, no promised land where you’ll always make the right trading decisions. There is only the *process* of seeking opportunities in an ever-changing market structure, and the *process* of making decisions free of the influence of emotional states that have been hard-coded in you, me, and every human being for thousands of years.

Everyone who reads this book will encounter a unique challenge, depending on knowledge, experience, and genetics. Even your current emotional state; how you *feel* influences how your brain creates connections, which then influences how you *act*.

That probably manifests in most readers as a desire to rush ahead to find actionable advice and immediately seek trades. This kind of urge is present in all of us. Unexamined, it has hindered many traders from the profitable careers they envisioned.

Can you put a price on patience? The cost of trading without it is extremely high.

The components of any financial transaction are time, price, and volume.

PREFACE

Only when an understanding of these fundamentals is deeply ingrained can we learn to identify herd behavior and wield our intuition, perhaps our most potent tool.

In order to beat the odds and end up ahead, you must confront the greatest obstacle of all – unlearning preconceived notions that lead to ineffective trading strategies.

We're so used to doing what we've always done that we don't stop to question whether it's the right thing to do at all. Many of our failures in performance are largely attributable to a lack of self-awareness.

— **James Clear**, *Atomic Habits*

INTRODUCTION

Over the years, I have purchased multiple copies of Shel Silverstein's timeless book, *Where the Sidewalk Ends*. The poem below is one of my favorites.

"Hector the Collector"

Hector the Collector
Collected bits of string,
Collected dolls with broken heads
And rusty bells that would not ring. Bent-up
nails and ice-cream sticks,
Twists of wires, worn-out tires,
Paper bags and broken bricks.
Old chipped vases, half shoelaces,
Gatlin' guns that wouldn't shoot,
Leaky boats that wouldn't float
And stopped-up horns that wouldn't toot. Butter
knives that had no handles,
Copper keys that fit no locks
Rings that were too small for fingers,
Dried-up leaves and patched-up socks.
Worn-out belts that had no buckles,

'Lectric trains that had no tracks,
Airplane models, broken bottles,
Three-legged chairs and cups with cracks.
Hector the Collector
Loved these things with all his soul –
Loved them more than shining diamonds,
Loved them more than glistenin' gold.
Hector called to all the people,
“Come and share my treasure trunk!”
And all the silly sightless people
Came and looked ... and called it junk.

BRIEF BACKGROUND ON THE AUTHOR

In 1972, I held memberships on both the Chicago Board of Trade (CBOT) and the Chicago Board Options Exchange (CBOE). You could say Hector was active in this chapter of my trading career.

Hector was sidelined a few years later when I became Senior Executive Vice President of the CBOE during its formative years. But after I left the exchange in 1979, he became active again.

It wasn't until the late 1980s that I attempted to shut down Hector once and for all when I collaborated with Eric Jones and my son, Rob Dalton, on my first book, *Mind Over Markets*; I stopped collecting every indicator and signal available.

As I read more and more about human behavior, neuroscience, and trading psychology, it became increasingly clear to me that “less is more” – successful trading is about leveraging the *right* information, not the *most* information.

When I became manager of a UBS institutional options trading desk, I began to systematically remove from our quote equipment many of the studies and indicators I had previously accumulated, just like Hector. After some initial pushback, we established a powerful trading desk, and many of my traders went on to enjoy notable careers.

The final confirmation of my anti-Hector philosophy emerged from Josh Waitzkin's book, *The Art of Learning*. Waitzkin was an international chess champion who also achieved fame in the martial arts, and one of his primary tenets was simple: "Depth beats breadth every time." (More on Waitzkin in the "Reading List" in Appendix B.)

In my last incarnation at UBS Financial Services as Director of Hedge Fund Research, I discovered that interacting with multiple hedge funds solidified the "depth beats breadth" observation, changing my trading philosophy forever.

In 2017, I founded Jim Dalton Trading (jimdaltontesting.com), dedicated to advanced trading, mentoring, and education with my partners Jennifer Loh and Raghu Rajput (RJ). Our immersive trading courses and mentoring programs are widely recognized for their breadth and depth. Numerous experienced traders have credited our courses for propelling them to new levels, providing them with a competitive edge by honing their instinct for what motivates their competition, and what drives ever-changing markets. We focus on teaching traders how to cut through the noise – not with magical theories, but by applying a potent combination of observation and practical application to influence probability-based trading decisions, free of biases and bad habits.

My lifelong pursuit of understanding the power of market-generated information (MGI) has been an ongoing labor of love, encompassing many of the chapters shared. That pursuit will continue as long as I'm able to continue to observe the beguiling, often bewildering ebb and flow of price, time, and volume.

HOW THIS BOOK IS DIFFERENT

I wrote *Mind over Markets* more than three decades ago in an attempt to examine and codify my burgeoning understanding of the power of MGI.

When you write, you're engaging in both *external storage* and *encoding*. You're "storing" important information, making it easier to review, while at the same time improving the encoding process that secures ideas in long-term memory. In other words, what you write down has a much greater chance of being recalled again.

If you can't write about it clearly, you don't understand it.

—Shane Parrish

Writing *Mind over Markets* and the follow-up *Markets in Profile* helped solidify and codify my trading philosophy, centered around the visual tool of the Market Profile.

In my early years running a trading desk, when a trade went bad, I handed the trader a yellow pad and asked them to write down their rationale for the trade. If the trader couldn't clearly describe the situation quickly and easily, I knew they didn't understand the trade and I'd give it to someone else on the desk.

At that time, I often spoke about "self-understanding" being a vital component for success, but I must admit that I was painfully light in that area back then. My first two books reveal this dearth, in that there is next to nothing written about how to develop that all-important component of successful trading.

Since those early years, I've done a lot of thinking, reading, and most importantly, *experiencing*. So, while this book has much in common with *Mind Over Markets* and *Markets in Profile*, it represents the culmination of

a career spent studying the way humans influence *market* behavior, and just as importantly, how markets (and the constant noise of the modern world) influence *human* behavior.

Importantly, we've eliminated strategies that I've since learned aren't viable. Concepts like "initial balance" and "range extension" – which I once investigated closely – have proven to be misleading and relatively unhelpful. Similarly, I used to detail the various types of market openings, which people loved because they seem programmatic... but they're simply not valid indicators.

I've weeded out those elements.

I was in Vegas speaking at "Traders for a Cause," and a young trader asked how markets have changed. I replied that volume has grown exponentially and hedge funds and large firms now buy order flow, giving them a fractional head start by shaving nanoseconds in order to pocket billions of dollars.

Institutions have always attempted to keep their orders private. Dark pools, which are private exchanges for trading securities, have continued to expand. With the advancement of technology, almost all orders – from single lots to large institutional orders – are entered via algorithms.

Another meaningful change occurred in March 2020 in response to the COVID-19 pandemic, when fiscal and monetary policy led to extreme liquidity. Charles Schwab reported that approximately 15% of its 30 million+ customers arrived in 2020. These inexperienced clients changed the market, contributing to increased volatility. I believe this increased liquidity has been siphoned off by more experienced traders.

But really, the basic components have not changed at all: time, price, and volume are still the fundamental mechanisms of any transaction.

What also hasn't changed – and this is amazing to me – is the continuing dependence on *momentum trading*, which is based solely on price. But a single dimension can never account for the necessary depth of understanding.

The Market Profile opened the door to more readily recognizing MGI. When it was first introduced, I struggled with the relationship between MGI and momentum. I now recognize that they're complementary – momentum is simply the leading indicator, and MGI is the lagging indicator.

MGI PUTS MOMENTUM IN ACTIONABLE CONTEXT

When I wrote *Mind Over Markets*, we were dealing with a novel technology; the Market Profile was a new tool for parsing real-time market activity, and as with any new technology, adjustments, refinements, and a deeper understanding of how best to *employ* that tool have developed over time.

Equally relevant, *Mind Over Markets* and *Markets in Profile* were both written before I had experience teaching traders how to use the Market Profile. I have dedicated the last three decades to mentoring and teaching traders how to understand indicators like momentum through the context of the Profile's constantly evolving distribution curve. This process has been a two-way street, as my extensive client interactions have educated me about the unique challenges that traders face, as well as the best methods for teaching them the fundamentals of market understanding.

In writing *Markets & Momentum*, we've culled both books, eliminating factors that have proven to be irrelevant. We've whittled it down to what is most important, adding depth around *self-understanding*, which can only be developed through consistent effort over time.

It's vital to embrace the fact that the greatest obstacle to your success is **you**. If you aren't aware of the fact that your subconscious is often driving your behavior – manifest in bad habits, illogical shortcuts, and the potent

engine of rationalization – then you may be making decisions based on invisible factors.

Until you make the unconscious conscious, it will direct your life and you will call it fate.

—Carl Jung

THE SUCCESS OF THIS BOOK DEPENDS ON BOTH OF US

This book was born of my desire to share the knowledge I've accumulated over a lifetime studying market and human behavior. We'll begin with Part I, a "Foundation" section that establishes key, non-linear concepts that must be internalized before you begin to trade. Read it, take notes (we've included empty pages in the back of the book), and begin your lifelong process of investigating your unique approach to processing information; it is only by discovering how your emotions, subconscious, and layered learning influence real-time decision-making that you can hope to become a successful trader.

Part II, the subsequent "Fundamentals" section will provide you with an essential understanding of the market's continuous, two-way auction process, as well as the theory behind the Market Profile, which is simply an intuitive way to organize and visualize this process.

Many members of the trading community believe I'm a "Market Profile trader." This is not true – I'm a *discretionary* trader who employs the Profile as an efficient tool for organizing the market's unfolding auctions. In all empirical pursuits, the better the data is organized, the greater the odds that you'll be able to glean important insights.

Having worked with traders and clients for half a century, I have recorded many observations. First and foremost: *It's too easy to become a trader*. With a few thousand dollars you can open a brokerage account and, boom: you're a trader. But by most estimates, the average trader's chance of success is painfully small.

Why do so many people lose? Statistically speaking, it should be impossible for so many people to lose. If the market is random—and most of the time, market momentum is indeed random—why do 90% of clients consistently lose a 50:50 bet? The answer is as simple as it is complex. It isn't the market beating them. They are beating themselves.

—**Tom Hougaard**, *Best Loser Wins*

As you focus on becoming a trader, understand that it's no different than becoming a surgeon, musician, or professional athlete; it's one thing to sit in the stands and critique a baseball game, and quite another to stare down a fastball coming at you at a hundred miles an hour.

A difficult challenge for short-term traders is that when you become part of a group there is a tendency to become like them. Remember, all the anecdotal evidence suggests that less than 10% of the group is profitable. Our surroundings influence us. We unconsciously become what we are near. As you adopt the behavior of those around you, the changes are often too subtle to notice until it's too late.

—**Shane Parrish**, *Clear Thinking*

PART I

FOUNDATION

CHAPTER ONE

THE SECRETS OF SUCCESS

We often read books as passive observers, letting the narrative wash over us without actively engaging in the experience. This is not that kind of book – you must join me as a *participant* if you wish to gain ground and move forward toward the pinnacle of expert trading.

Even as a willing participant, however, it can be difficult to orient yourself unless you know where you are, as a trader, right now. To respond to this challenge, it's necessary to conduct an honest self-assessment. The following guidelines are designed to assist you in this endeavor.

The majority of successful traders I've known are far more productive when engaging in *go with* trades; they often execute trades in the direction of the salient trend. If they're day traders, "go with" means following the daily trend, or "developing value" (an important pattern we'll address later in the book). Swing traders, on the other hand, tend to execute based on the intermediate, or longer-term trend.

Most short-term, non-professional traders have taken courses that preach “reversion to the mean.” They’re also taught to wait for signals that confirm a trade. In my experience, successful traders actually *shun* reversion-to-the-mean trades!

In today’s fast markets, waiting for confirmation often results in missing profitable trend days (we will discuss trend days in Chapter 14).

SUCCESS REQUIRES CONSTANT PLANNING AND REHEARSAL

In my educational seminars and programs, we frequently refer to “homework,” as in, “If you haven’t done your homework, you haven’t earned the right to trade.”

All traders have great intentions, but family, friends, news items, and myriad other commitments and interruptions can transform these intentions into regrets. In order to make progress on the road to becoming a successful trader, you’ll have to take a close look at your intentions and tendencies and accept some potentially difficult truths about how you process and act on information. But that’s the game. And you either play it with an open, focused mind, or you get played and join the more than 90% of short-term traders who lose money in the markets.

Do you double down on losing trades? This is one of the most dangerous habits inexperienced traders suffer. A wise person once said, “When you’re in a hole, stop digging.” The use of the word “habit” here, is deliberate. In Chapter 6, we’ll review actionable approaches to changing the habits that decrease our odds of success.

Which brings to mind a metaphor that might prove useful as you assess your own inclinations. Neuroscience makes it clear that our standard

modes of thought become *physically ingrained*; when we think the same thoughts over and over, we forge neural pathways – superhighways of brain activity that become increasingly easy to traverse.

Changing mental habits is tantamount to scratching out a path through tangled undergrowth away from the highway. The going can be rough.

Imagine how time-consuming it would be to use a machete to cut your way through thick foliage. A few miles could take days. Once the path is cleared, however, you could move quickly through the clearing. If you were to make a road and ride a bike or other vehicle, the transportation would get faster still.

—Josh Waitzkin, *The Art of Learning*

This metaphor is handy because it reminds us that only by *continuing* to beat a new path – through daily practice – are we able to establish new, more productive avenues for thought. As we’ve established, the superhighway of trader habits does not lead to financial success, so you must ask yourself: *Am I willing to forge a new path through focused, repeated effort?*

Here’s a (partial) list of the types of mental tendencies that cause traders to lose focus/time/money:

- Doubling down on iffy trades
- Good old-fashioned FOMO (fear of missing out)
- Unceasing eagerness to take profits
- Fading trend days
- Failure to let profits run
- Reading every bit of news/analysis (almost guarantees cognitive dissonance – addressed in Chapter 6)
- Trusting a “gut feeling” (which is more likely a temporary emotional urge)

The popular writer/psychologist Malcolm Gladwell developed the Diffusion Model as a way to judge where you are most active. The scale also comes in handy when assessing competitor behavior – and your own:

- Innovator
- Early Adopter
- Early Majority
- Late Majority
- Laggard

SELF-ASSESSMENT: WHERE ARE YOU MOST ACTIVE ON THIS SCALE?

Self-awareness is key to being able to combine your skill, experience, and knowledge – the trifecta that gives you slightly better odds of trading with less risk. Few traders process this fact, and fewer still have even thought about it.

But I guarantee: *Self-assessment is the starting point for achieving success.*

In Appendix B, I've listed a number of books that helped me better understand the way I process information, emotions, and the endless noise that courses through our screens. I highly recommend you read them – perhaps even before you continue with this book – to improve your capacity for self-assessment. At least begin reading them in conjunction with this book, as they are an integral part of the experience.

You cannot change your destination overnight, but you can change your direction overnight. Success is nothing more than a few simple disciplines, practiced every day.

—**Jim Rohn**, Entrepreneur, author, and motivational speaker

CHAPTER TWO

NUANCE

This book is about *nuance*.

My doctor is one of the most esteemed internists in Scottsdale, widely respected for his focus on subtle clues often missed by other specialists. He once asked me what I did, and I told him I wrote books on trading. He responded, “That can’t be worth much, because trading – like medicine – is about nuances.”

He was wrong to assume that I wasn’t nuance-oriented, but he was absolutely right about the importance of those subtle clues that most traders consistently miss.

Nuance means “subtle difference in meaning,” and when applied to trading, it indicates the challenge before every trader: *How can I discover opportunities in unfolding market structure?*

Trading is a nuanced art. This book is about learning to find clues in the way the market moves. What follows is a series of observations that create focus areas for your ongoing practice.

FLOOR SCALPERS

“Scalping” originally meant people shouting and gesturing at each other in a pit. This frenetic activity provided liquidity, and scalpers were able to buy on bid and sell on offer with no commission on break-even trades.

Some still endorse scalping as a “low-risk” activity, but the odds are now stacked against you. First, off-floor scalpers buy on *offer* and sell on *bid*, and they’re paying commissions – whether visible or not. Scalpers are also up against mega-firms like Schwab selling order flow to large hedge funds. These funds have massive computing power and get to see the public order flow milliseconds ahead of the average trader, their algorithms transforming micro-head-starts into billions in profits.

I have only anecdotal evidence, but it seems less than 5% of floor scalpers ended up making any money screen trading; they no longer had the physical advantages of the trading floor, and weren’t able to adopt new practices.

Information on the floor used to come through sound. If prices were going up and the sound level increased, you were likely to see continuation. If price levels were going up and the sound diminished, odds are the rally was coming to an end. Experienced traders almost intuitively had their palms facing the crowd at this point (selling).

Conversely, when trading from an electronic screen, sensory information reaches your brain through your eyes. Many floor traders never realized the significance of this transition.

IRRATIONAL MARKETS AND PREDICTABLE HABITS

Long before I had heard of behavioral economist Dan Ariely, I believed that while financial markets can be irrational, trader behavior can sometimes