
Markets in Profile

*Profiting from the Auction
Process*

**JAMES DALTON
ROBERT BEVAN DALTON
ERIC T. JONES**



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Markets in Profile



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To all those intrepid traders who – from this day forward – will
accept both the financial and emotional risks inherent in
making that final decision to buy or sell.

Contents

Preface	xi
Acknowledgments	xix
CHAPTER 1 The Only Constant	1
<hr/>	
The Creation of ERISA	4
The Rise and Fall of Relative Performance	4
The Fall of the Great Bull	6
The Rise of Absolute Return	7
Succeeding in an Absolute Return Market Environment	8
Pure, Unbaised Information	10
People Change Markets, Markets Change People	13
CHAPTER 2 Information	15
<hr/>	
Fundamental Information	16
Rational or Irrational?	18
Market-Generated Information	19
The Auctions	20
Fair Value	21
Market Profile Fundamentals	22
Authors' Note	22
Demystifying Market Behavior	27
CHAPTER 3 Timeframes	29
<hr/>	
Breaking Down Market Timeframes	31
Scalper	32
Day Trader	32

Short-Term Traders	32
Intermediate Traders/Investors	33
Long-Term Investors	35
Your Timeframe Is your Strategy Cornerstone	39
CHAPTER 4 Auctions and Indicators	41
<hr/>	
The Search for Value	42
Concept Review	45
Key Market-Generated Indicators	48
Perfecting the Art of Visualization	56
CHAPTER 5 Long-Term Auctions	59
<hr/>	
Auctions in Action	60
The Compound-Auction Process	61
The EBB and Flow of Balance	62
Where Do Trends End and Brackets Begin?	64
Clarity in the Maelstrom	66
The Big Picture	68
Asymmetric Opportunities and Risk	72
Long-Term Strategy Development	74
Assembling the Big Picture: Context within Context	75
CHAPTER 6 Intermediate-Term Auctions	77
<hr/>	
Convergence and the Bracketing Process	77
Defining the Intermediate Term	79
The Transition from Bracket to Trends	80
The Transition from Trend to Bracket	82
The Convergence of Intellect and Emotion	85
Accelerate the Learning Process	86
Prelude to a Sea Change	87
Hear the Bells A-Ringing	94
Countertrend Auctions	94
The Quest to Do Better than “Normal”	96
Oh, the Difference a Few Points Makes	97

CHAPTER 7	Short-Term Trading	99
<hr/>		
Analyzing Short-Term Markets		101
Common Mind Traps		104
When and Where to Look for Short-Term Trades		105
Opportunities Around Intermediate-Term Brackets		106
Technical Indicators		106
Your Own Worst Enemy: Your Brain		110
Seeking the “Exceptionally Tasty Patterns”		112
All Prices and Opportunities Are Not Equal		116
Ongoing Forensic Investigation		121
Looking for the All-Important Reference Points		124
Never Be a Laggard		129
A Golden Opportunity		130
Fade the Extremes, Go with Breakouts		132
“The Expert Reasons Contextually”		137
CHAPTER 8	Day Trading Is for Everyone	141
<hr/>		
What’s a Day Trader to Do?		142
What You Don’t Do May Be More Important than What You Do		145
The Real World in Action		146
Top Down		152
Lack of Conviction		152
Flight to Safety		153
Inventory Imbalances		154
Correction of Inventory Imbalances		155
Trend Traders’ Trap		157
Market Condition		158
Yesterday’s Trade		162
Example 1		162
Example 2		165
Example 3		167
Trader Checklist		170

The Market Is Open	171
Open-Drive	171
Open-Test-Drive	175
Open-Rejection-Reverse	178
Open-Auction	181
Day Trader's Checklist	181
Example 1	183
Example 2	185
Example 3	188
Practice, Practice, Practice	190
CHAPTER 9 Profiting from Market-Generated Information	193
<hr/>	
Timeframe Diversification	194
The New Paradigm	196
Appendix A: Market Update	199
About the Authors	201
Index	203

Preface

You can manage risk but not return.

—Peter Bernstein

This book is about gaining an advantage over your competitors. To achieve this advantage, you must first discard the belief that there is a linear relationship between risk and reward. The primary objective of investing (and trading) is to identify asymmetric opportunities. To capitalize on these opportunities, you must learn to identify imbalances that reveal themselves in evolving market structure. But that is only the beginning—you must also understand the way you process and respond to information, so your ability to act is not blocked or distorted by peripheral influences.

Markets in Profile: Profiting from the Auction Process introduces a unified theory that explains the market's auction process in relation to the human decision-making process, and the way market behavior affects human behavior. The bottom line? You are equipped to manage risk, which puts you miles ahead of the pack.

MARKETS ARE RATIONAL, PEOPLE ARE NOT

The “efficient markets” theory is half right. The market’s mechanism for allocating prices is extremely fair. It’s a simple two-way auction process by which price moves over time to facilitate trade either up or down—an extremely rational, efficient process.

The other half of the efficient market equation, however, is often wrong; people are seldom rational when they make financial decisions. The first step toward more profitable investing is to accept that market irrationality is due to the fact that people make decisions based on (unavoidably) incomplete information, which often results in the worst decisions being made when it is most important to be right.

Human nature is such that we tend to overweight information that supports our presupposed inclinations. We seek out a few pieces of the bigger

picture that make us feel confident in our decisions. This recurring *overconfidence* is behind the idea that markets are “irrational in a predictable manner,” a landmark theory put forth by Nobel Prize–winning psychologists Daniel Kahneman and Amos Tversky.

But Kahneman and Tversky didn’t take this information to the next level. They didn’t explore how to take *advantage* of that fact. In this book, we show you how the auction process both records and reveals market structure—and how, within that structure, predictability manifests itself in recognizable forms such as the “excess” that occurs at the end of an auction. We show you how excess is formed, too, and how to view it objectively in order to better manage risk.

All markets alternate between periods of stability and crisis. By monitoring market structure in real-time context, it is possible to recognize paradigm shifts in equilibrium. Market indicators such as excess make it possible to identify when the status quo is changing, which results in opportunities to distinguish favorable (and unfavorable) investment opportunities. In other words, it is possible to ameliorate risk by recognizing imbalances caused by irrational human behavior such as the herd instinct, which pushes price away from value.

Everyone talks about the problems of investing and market behavior. We are proposing a solution, a means of interpreting market behavior through the lens of human consciousness, and then quantifying that information in a way that enables investing on a more probabilistic basis.

IS THIS BOOK FOR YOU?

Authors’ Note

While this is a collaborative work, the rest of the preface and many of the experiences shared throughout the book are written from the perspective of lead author Jim Dalton, who has spent his career furthering his understanding and mastery of the markets.

As the lead author, I’m often asked if I’m writing for investors or traders. I believe such distinctions are in many ways arbitrary for there is no line where one stops and the other ends. It’s a spectrum, and every individual and every institution falls on a different point. That point changes constantly depending on the phase of activity. Even the longest-term investor should change his decision-making process in order to exit or enter a position. Trim, add, raise cash, change asset allocation—these are all timing decisions.

In *The Tipping Point*, Malcolm Gladwell could have been writing about markets when he described crime as not “a single discrete thing, but a

word used to describe an almost impossibly varied and complicated set of behaviors.”

Perhaps you're a growth investor. Or a value investor. Large cap, small cap—most institutional investors tend to pick a style and stick with it. The theories in this book are not dependant on the condition of the market, nor on what style is currently in favor. In fact, much of the power and appeal of these theories is that they are *totally agnostic* in terms of style, cap size, and asset class. The concepts you encounter are equally applicable to any style of investing, any timeframe, even any market, because the auction process works equally well for futures, real estate, art, even eBay.

The core idea is simple: all financial markets are measurable by time, price, and volume. This multidimensional approach to interpreting market-generated information enables you to differentiate between prices, because all prices are not equal. By extension, all opportunities are not equal, which is key in managing the probabilities of risk.

THERE IS NO CERTAINTY—THERE ARE ONLY PROBABILITIES

Markets react to countless influences other than fundamental company news. There are natural disasters, terrorist attacks, wars, and political imbroglios that cause markets to become too long or too short in different timeframes. It is often the shorter-term uncertainties that can make or break a money manager, putting sizable divots in the results investors use to choose fund allocation. One bad quarter can sink a portfolio and mar a stellar five-year track record.

Modern portfolio theory depends heavily upon diversification by asset class, sectors, individual securities, and so on. One of the core tenets of this book is that such diversification is not enough—you *must also diversify by timeframe*. Timeframe diversification is a staple for fixed income managers, who frequently diversify by owning short-, intermediate-, and long-term instruments. This approach should be natural for equity investors and investment advisors as well.

Successful timeframe diversification can help hedge against the major liquidating breaks, short-covering rallies, and other short-term market movements caused by news events that can push markets to the breaking point. What I'm getting at is that managers often throw in the towel at *exactly the wrong time*. This is undoubtedly why there's a saying that markets will trade to levels that cause the most pain for the greatest number of investors.

Change is the great common denominator. When change occurs, we are most vulnerable, and the natural human tendency is to grasp for what is

familiar, what has “worked” before. That’s why it is so important to learn to identify the basic structure of change through conscious attention to evolving market conditions. Recognizing the patterns that precipitate change can make the difference of a couple hundred basis points. And that, in a highly competitive world, can be the difference between feast and famine.

An investor or investment advisor who understands that markets do not change in a linear fashion, and that risk and return must be managed by interpreting change as it occurs in the present tense, is better able to recognize and capitalize on risk asymmetries. Ultimately, that is what distinguishes the successful investor from both the long-only and absolute schools of thought.

KNOW THE MARKET, KNOW YOURSELF, MANAGE RISK

The world wants absolute answers. This is why we are being careful to note that what we are suggesting is not an academic model to replace the efficient market hypothesis. The conundrum is that mathematics and factor-model approaches are more consistent than human intuition, but they don’t allow for enough flexibility to respond to rapidly changing market situations. They don’t allow you to distance yourself from competitors who apply similar models. It’s like watching the world championship of poker—all the good players know the odds. That’s why winning takes another level of understanding.

This book separates the market mechanism from the investor. While it is possible to describe the workings of any market within a single coherent framework, that knowledge represents only half of the equation. It is not enough to grasp how markets work; you must also understand how you take in and process information, and then execute based on that information. This concept has gained currency since “Prospect Theory” established that we are not rational decision makers. Our emotions can weaken or completely eliminate our self-control . . . but we’ll save a thorough discussion of human behavior and neuroeconomics for a later chapter.

We’re simply suggesting that traditional fundamental analysis can be enhanced with *real-time context*—time, price, and volume. By interpreting analysis in relation to market-generated information, the investor can better understand the nature of change, which can positively influence trade location. Trade location is the key to controlling risk and taking advantage of asymmetric opportunities that occur within developing market structure.

In recent years, the bifurcation of the brain has been explored thoroughly in popular media. We are not the first to suggest that successful

investing (or successful *anything*) incorporates both sides of the brain. The goal is to balance the analytical hemisphere, made manifest in vital fundamental research, with the pattern recognition of the intuitive hemisphere in a present-tense process.

We're talking about *whole-brained investing*—a holistic, context-based understanding of market activity. As in all things, balance is the key to success, a concept that will appear throughout this book.

SO WHY LISTEN TO ME?

I've spent my entire career in and around the markets. That experience has resulted in two fundamental beliefs: First, that intelligence and understanding do not necessarily go hand-in-hand, and second, that patience and self control can be illusory.

I entered the industry nearly 40 years ago as a broker for a major Wall Street firm armed with a strong sales record and the belief that my success depended only on selling the stocks that my research recommended. I was a good salesman, but I was naïve and inexperienced. I didn't know it at the time, but it would take many years of learning and hard work before I could confidently say that I was consistently making money for myself, my firm, *and* my clients. I have tried to forget the financial pain I inflicted during those early years (as well as the psychological pain I endured from failing to meet my own expectations). Some of that cognitive dissonance resulted from poor stock selection, but some was from a lack of experience that kept me from cautioning customers against their own ideas.

When I first became a broker, the importance of raising capital was impressed upon me. The job was vital, I was told, because capital "nourishes our country." I quickly learned that no one really cares about the capital-raising function unless they own the company. Clients? They just wanted to purchase winners and get rich. This realization shaped the central motivation of my professional career: to independently seek profitable situations for my clients.

It was made very clear to me at the time, however, that I was expected to follow the firm's research. After all, the research department was comprised of the brightest minds on Wall Street. During my initial broker-training program, an economist who is still widely recognized told us that he wasn't interested in buying any stocks that were then available. When I returned to California after training, that economist was no longer employed by the firm. Soon after, a widely respected analyst suggested that there were very few buy candidates among the stocks that she followed. She was allowed to keep her position, but was reportedly placed on probation. Around the

same time, which was just prior to the Bear Market of the early 1970s, I bought some energy and gold stocks, which were profitable for clients, only to have my commissions rescinded because the stocks I bought were not on the firm's "recommended list."

I began to observe surprising behavior in some of the stocks that were purchased from the recommended list. They declined *significantly* following higher than expected earnings. I became enamored with the slogan "buy the rumor, sell the news." The problem was that it didn't always work. Over time I observed that although the analysis of a company was often correct, the market's ensuing movement wasn't always consistent with that analysis. This is where I learned that fundamental analysis enables only a partial understanding of the bigger picture.

I changed firms with a big check in hand, as well as the assurance that the next firm's research was superior to that of the prior firm, and that my world would turn around. This was during the Bear Market of the 1970s and the market was on its way down to 500 from 1,000. Nothing worked. Right near the bottom, I learned how to short stocks and was successful with my first two shorts. The next short was Fannie Mae, which only required 25 percent margin. Do I need to continue?

One of the pivotal experiences in my life began there, at the bottom of the market: I became interested in buying and writing options. In those days, the options business was conducted through a series of independent put and call dealers who matched buyers and sellers in nonfungible transactions. During this same period, I had another introduction to the early derivatives markets when Edward O. Thorp, the legendary card counter, trader, and coauthor of *Beat the Dealer* and *Beat the Market: A Scientific Stock Market System*, opened an account with me. What his firm would do was buy stocks and sell warrants against those stocks, knowing that they would converge at expiration. My recollection is that their returns were in the 20 percent range.

In the early 1970s, my experience with options and warrants brought me a job offer from Joe Sullivan, who was the first president of the fledgling Chicago Board Options Exchange (CBOE). I gave up my memberships on both the Chicago Board of Trade (CBOT) and the CBOE to join Joe. As an executive vice president of the CBOE during its formative years, I was exposed to the various segments of the securities industry as well as the hordes of academics who were then conducting research and engaging in financial engineering involving options and other derivatives. During this period, I observed that a lot of firms and individual traders that employed single strategies—strategies that were highly successful for a while—saw those same strategies implode during economic crises caused by system abuse and overextension. I began to understand that no single strategy can work (for long) for all markets; those with

superior results over the longer term were flexible, adaptive to changing conditions.

I observed how often, at major tops and bottoms, the experts and institutional investors seemed to share similar beliefs—beliefs that were simply wrong. I realized that long-term forecasting is unreliable because unforeseen events are bound to occur. I came to the conclusion, during these periods, that being skeptical, value oriented, and independent were far more important than being with the majority, especially at the extremes.

Even though I began to better understand what it takes to be successful, I was still never comfortable moving against the crowd. We are social animals after all, longing to belong. We all want to be part of a larger family, and every decision we make is in some way influenced by that desire.

In the late 1980s, I was introduced to a new theory, a method of arranging data that allowed me to see how markets are organized. I met Peter Steidlmaier, who is credited with developing *Market Profile*[®] for the Chicago Board of Trade (CBOT[®]), a graphical organization of price and time information that displays price on the vertical axis and time on the horizontal axis—the decision support tool for traders used in this book. Peter asked me if I wanted to sponsor the book that he and Kevin Koy were writing. I immediately recognized the value of this new concept and delivered a check for \$10,000 to sponsor *Markets and Market Logic* (Philadelphia: Porcupine Press, 1986). My son Rob Dalton, Eric Jones, and I then expanded and elaborated on Pete's work in *Mind Over Markets* (New York: McGraw-Hill, 1990), which provides a wealth of tactical trading information. I'm happy to report that in 2005 *Mind Over Markets* has been published in a Chinese edition.

After spending several years trading on my own and mentoring other traders, UBS (Union Bank of Switzerland) Financial Services asked me if I would return for a fourth time and reorganize their nonproprietary hedge fund business. This resulted in another significant pivot point in my career—as manager of Hedge Fund Research, I was in direct contact with many premier hedge funds and successful traders.

Having established an efficient process for reviewing hedge funds, my firm then offered me the position of director of research for managed accounts, a position that I was responsible for until I retired in August 2005. In this role, I was exposed not only to hedge funds but also to more traditional firms, some of which had upward of a trillion dollars under management.

I was surprised to discover how poor the actual results were for many of these relative-return firms, especially on a long-term basis. While some may have had decent relative returns (within their peer group), the absolute returns were often disappointing. I feel safe in suggesting that most hedge fund and relative-return managers could significantly benefit from the concepts in this book.

A long time ago, at the beginning of my career, I became the number-one salesman at IBM by meeting with clients, upsetting their homeostasis and then giving them a solution to resolve their state of unease. That model is still working for me today. *Markets in Profile* offers a new, holistic theory for market understanding.

For the inquisitive spirit, I believe this book provides the basis for profound insight into a more coherent form of risk management. (And it's a fun read.)

Acknowledgments

We have singled out a few individuals and organizations for having provided definitive insight or support; *Markets in Profile* was born out of years of teaching, research, and trading.

J. Peter Steidlmayer pioneered the original theories that served as our continual point of embarkation for both *Markets in Profile* and our earlier book, *Mind Over Markets*.

Brett N. Steenbarger was introduced to us after he read *Mind Over Markets* from the world of “protected academic medicine,” as he put it (Brett was assistant professor of psychiatry and assistant dean of the College of Medicine, SUNY Health Science Center at Syracuse). Brett wrote us a two-part response to the book, spanning more than 60 pages, that was heavily focused on the, you have a healthy understanding of both markets and your *self*. Brett connected the structure of the market profile with the ways in which our brains efficiently collect and visualize information. He also introduced us to formative theories on how change occurs in both individuals and organizations. This well-reasoned response triggered several years of reading and research that led to a deeper understanding of cognition, behavioral finance, and neuroeconomics (you will notice that there are far more references to books relating to these subjects than there are to books that explicate market mechanics in *Markets in Profile*). One of the fundamental keys to successful trading, we believe, is understanding how markets change people, and how people change markets.

CQG, for their quality ongoing technical support over the years. CQG is responsible for many of the charts and data presented in this book.

WINdoTRADEr, a software utility that allows for the flexible implementation of Market Profile graphics and provides features for performing volume analysis. We have worked closely with WINdoTRADEr, consistently offering suggestions for improving this helpful, fully customizable utility.

Each of the three authors has contributed to *Markets in Profile* in a unique way. Stylistically, the book was written from the perspective of James Dalton, who has dedicated decades to an active, intense involvement

with the day-to-day markets. Rob Dalton is a professional writer (and occasional poet) with an exceptional ability to translate complex ideas into a clear, compelling dialogue. Eric Jones, Jim's original trading partner, has researched, studied, and written about the markets and foreign exchange for many years. Having spent the past several years as a senior officer with one of the world's largest financial services firms, Eric contributed a wealth of experience with the Market Profile, and provided guidance in developing concepts that would resonate with other senior officers of financial services firms.

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CHAPTER 1

The Only Constant

It is not necessary to change. Survival is not mandatory.

—W. Edwards Deming

My first car was a used '49 Chevy. We could pull it into the garage and change the plugs, set the timing, clean the carburetor and be on our way. Back then, it was relatively easy to understand engines and how to keep them running smoothly. Today, if someone asked me to explain the first thing about what's happening under the hood of my car, I wouldn't have a clue.

There's a parallel between that Chevy and my first excursion into the world of investing. When I became a stockbroker in the late sixties, my choices were pretty simple: common stocks, preferreds, a few warrants, limited over-the-counter options, U.S. government treasuries, municipals and corporate bonds, and cash. While there were mutual funds, they were extremely limited and many brokerage firms discouraged brokers from selling them to customers.

The financial markets have moved from simple to complex at a rate of change that is impossible to fully grasp. This accelerating complexity has been multiplied by the Internet explosion, global expansion, and myriad other factors, leaving individual traders and investors bewildered and grasping at narrow fragments of the larger picture, or subscribing to the beliefs of supposed experts who promise clarity and shelter from the information maelstrom. It's no wonder that the current financial atmosphere is one of continual change and uncertainty.

In his landmark book, *The Structure of Scientific Revolutions* (Chicago: University of Chicago Press, 1962), Thomas S. Kuhn examines