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# Markets in Profile

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*Profiting from the Auction  
Process*

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



John Wiley & Sons, Inc.

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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.

# 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 Steidlmayer, 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 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

**M**y 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 the way change realigns the "received beliefs" of any given community; because a community's participants define themselves according to the ideas they share, they often take great pains to defend those ideas. In fact, it's not uncommon for this defensive posture to result in the active suppression of new theories that undermine reigning assumptions. Therefore research, Kuhn writes, is not about discovering new truths, but rather "a strenuous and devoted attempt" to force new data into accepted conceptual boxes.

In short, change threatens the very terms with which we identify who we are (and how we invest our money).

But history has proved that in all things stasis never lasts—eventually an anomaly arises that is so compelling it cannot be ignored or dismissed as a "radical theory." Inevitably, the anomaly unseats the norm, resulting in a paradigm shift in shared assumptions. These shifts, as Kuhn describes them, are nothing short of revolutionary.

Paradigm shifts force a community to reconstruct its foundation of belief. Facts are reevaluated. Data are examined through new lenses and, despite vehement resistance by those who refuse to let go of outdated ideas, the old paradigm is overthrown. A new community is established, and the "radical theories" are accepted as the new normative establishment.

The cycle of change begins again.

How important is change? Think about the many powerful institutions and intrepid individuals that once lead the fray and who are now long gone; those who recognize change early can take advantage of change, those who can't overturn their past beliefs get left behind. That pattern repeats itself endlessly in all human endeavors.

In *The Tipping Point: How Little Things Can Make a Big Difference* (Boston: Little, Brown, 2000), Malcolm Gladwell defined the way people react to change by classifying them on a spectrum:

**innovators : early adopters : early majority :  
late majority : laggards**

We are going to show you how to use market-generated information to identify and adapt to change before your competitors—once the majority recognizes that change is occurring, all asymmetric opportunity is lost. This book challenges you to be an innovator, to overturn (change) many of the assumptions that now guide your perception of economic and market conditions. You may be faced with information that runs counter to the prevailing beliefs of those whom you have trusted for guidance. Daniel Kahneman said it best: “Resistance is the initial fate of all new paradigms. Often this resistance is strongest among the institutions responsible for teaching and upholding the status quo.”

To begin, we address change in the financial markets from the broadest perspective, which is from the point of view of investors who operate in the longest timeframe. But it is important to note that this same process occurs for traders/investors of all timeframes—those who capitalize on five-minute price swings, day traders who make several daily decisions, short-term traders who hold positions for

several days, intermediate-term traders who track bracket extremes, as well traders who hold their positions for several months or even years.

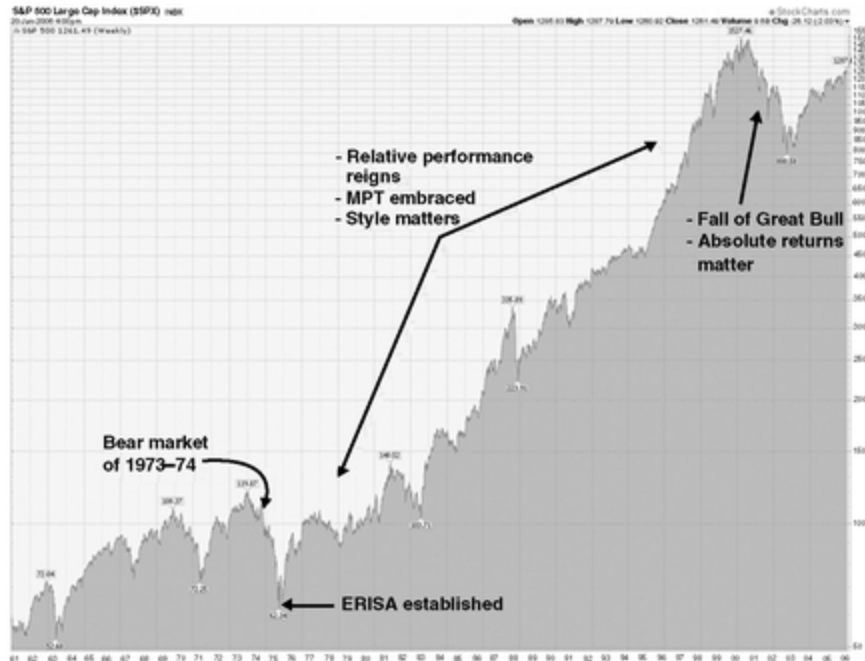
*What we are addressing, across all timeframes, is how change occurs.*

We believe that the financial markets—and therefore all participants, businesses, and industries dependent on the markets—are at the vortex of a truly significant change. Over the coming years, investors, traders, portfolio managers, financial advisors, pension consultants, and even academics will all have to pick their spot on the spectrum of change ... and win or lose because of it.

There is no single key driver behind the change we're experiencing. Rather, a series of developments—some connected and some not—over the past 30 years have created the evolution that is now underway. The balance of this chapter introduces these events and their implications on the financial markets and those who operate within them (traders, portfolio managers, advisors, etc.). To help you visualize the following discussion, [Figure 1.1](#) illustrates several key developments of recent market history in the context of the U.S. equity market.

**[FIGURE 1.1](#)** Events shaping market and investor behavior: S&P 500, 1965 to 2004.

Source: Chart courtesy of [StockCharts.com](http://StockCharts.com).



## THE CREATION OF ERISA

The first serious change in the modern financial services business took place in the early seventies, partly as a result of the U.S. bear market that culminated in October 1974. Leading to the trend's nadir, equity valuation had decreased by approximately 40 percent (see [Figure 1.1](#)), the bond market had dropped an equivalent amount, and there was an estimated 35 percent decline in purchasing power. It should come as no surprise that innovation flourished under these extreme conditions; change demands the surrender of security, and in 1974 the very notion of security was cast in doubt.

Not surprisingly, new government regulations designed to protect employees' hard-earned retirement funds followed closely on the heels of this cataclysmic plunge. Enter ERISA (Employee Retirement Income Security Act), enacted in 1974 and designed to protect employee pensions. While