

Wiley Trading Series



MIND OVER MARKETS

POWER TRADING with
 MARKET GENERATED
INFORMATION

James F. Dalton • Eric T. Jones • Robert B. Dalton

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UPDATED EDITION

Power Trading with Market
Generated Information

**James F. Dalton
Eric T. Jones
Robert B. Dalton**

WILEY

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Preface

When *Mind Over Markets* was first published in 1990, the Market Profile was relatively new. I was fascinated by the utility because it provided a new way to structure information, a new way to look at the market through a time-sensitive, evolving database that records the market's continuous two-way auction process.

I had long been skeptical about analysis that treated all prices as equal. After years studying market behavior—with membership on the Chicago Board of Trade and as a founding member of the Chicago Board Options Exchange—I came to the conclusion that fundamental analysis is generally too long term, often appearing out of touch with the market. Auction market theory, on the other hand, seemed to offer the most objective means of allocating the constant flow of bids and offers.

I embraced the idea that auctions are mechanisms for price discovery.

Mind Over Markets is a practical handbook for developing an understanding of market behavior that will help you trade with the odds in your favor. And in the 20 years since it was first published (and translated into Chinese and French), my co-authors and I have continued to delve deeper into the application of auction theory to trading and investment decisions.

In the first printing, we talked about “buying and selling tails” in Profile structure. We'll get into the mechanics of this concept later in the book, but we mention them here, in this new introduction, because they represent an example of how our understanding has evolved since the original publication, thanks to the best teacher of all: *experience*. We still believe in the structural significance of tails, but we

have developed a more nuanced appreciation for what *causes* tails, or more tellingly, what causes the *lack* of a tail (an indication that the market has gotten too long or too short).

This understanding—like all understanding—evolved over time. It is the *context* surrounding the indicator that signals a deeper layer of meaning. Factors like volume and tempo provide clues about which timeframe is leading market movement. And as you'll discover, discerning timeframe influence is one of the most important insights you can develop as an agile-brained trader.

Does the Profile Still Work, after All These Years?

I'm often asked if the Profile works. Or, more commonly, if it still works. The better question is this: Is the Market Profile a valid scientific way to organize data?

The answer to that question is a definite yes. The Profile is constructed using a constant—*time*—on the horizontal axis, and a variable—*price*—on the vertical axis to form a distribution. Scientists have employed this method to study and observe data for generations. Personally, I would much rather study organized data than unorganized data; the Profile is simply a valuable tool for organizing objective information.

After a lifetime spent observing markets, I choose to give more emphasis to the Market Profile—with its evolving, multidimensional structure—because I believe it provides a more accurate representation of the auction process, *as it unfolds*. It smooths out aberrations, such as high volume at the opening bell, as well as statistical references like the overnight high and low that can mislead you in the heat of the moment.

To be clear, I'm a trader, not a Profile trader. However, the Profile has been invaluable to my analysis, and it has enabled my personal evolution through decades of reading and interpreting data in its ever-changing visualizations. Over time, my knowledge has deepened through practice—and not just practice, but *correct* practice. Choose any sport and you'll recognize the importance of practicing a correct stroke/shot/swing; practice wrong and you'll cement bad habits that can take years to unlearn.

One of the most astute [Amazon.com](https://www.amazon.com) reviews for this book was not intended as a compliment—the reviewer said *Mind over Markets* is “too complicated.” Those two words capture the reason why most traders fail, as well as the reason why the book in your hands is still relevant, challenging, and insightful after two decades: It was written for serious traders, and it doesn't purport to be a total solution.

Ultimately, you must make your own decisions as you carefully choose which tools you use, and which indicators you follow as you trade. Rest assured that no matter what you decide, there is never a single, simple answer. I suggest you compare volume profiles and Market Profiles side by side, writing down your observations as you see how they mirror and/or contradict each other. Constantly ask yourself, *What does the ambiguity tell you? Can you identify change before your competitors (mostly laggards) transform opportunity into the familiar patterns of consensus?*

On the Long Road to Expert

In reading this book, you will begin to make progress on your path to becoming a successful trader. Over time, you will transform insights into instincts in the kiln of experience. And those instincts will help you rise above the distracting maelstrom of conflicting information with a broader, more *holistic* market perspective. You will begin to

understand the big picture, while also participating in the daily minutia—the hallmark of a professional trader.

Developing this level of market understanding is not an easy process. Most people find it impossible to even begin to parse such an overwhelming amount of ambiguous, conflicting information, let alone transcend it. But armed with *awareness*, you have the ability to separate yourself from your competitors, most of whom are lost in the shallows of price and opinion. You have the opportunity to forge your own path toward expert.

Good luck on your journey!

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Our thanks to the individuals and organizations named below extends far beyond the scope of the writing of this book. *Mind Over Markets* is born out of years of teaching, research, and trading. In one way or another, the following individuals and companies have made a significant contribution to this effort:

Second edition acknowledgment is to *Julia Stuart*, my partner at J. Dalton Trading, who has worked with me over the past several years as a student, a fellow trader, writer, and editor.

J. Peter Steidlmayer, who pioneered the theories upon which much of our work is based. When I met Pete in 1985, one of the first questions I asked was “If your theories are so good, why share them with anyone else?” Pete's response was not what one would expect from a successful commodity trader. He said, “The market has been good to me. Like Marshall Field's contribution to the city of Chicago was the Field Museum, my contribution to the financial world is a better way to trade.”

Peter Steidlmayer has always encouraged his students to take the information he has provided and make it their own. In less than five years, we have witnessed the birth of new types of quotation software, databases, and all forms of expanded market research. Such is the natural process that follows any significant new discovery. Given the magnitude of the contribution that Peter Steidlmayer has made to the financial markets, this information expansion will likely continue for a long time.

Norman Hovda, who, as a broker in the Soybean Meal pit at the Chicago Board of Trade, observed Pete Steidlmayer as he came into the pit to trade. It was Norman who first

introduced me to Pete, and that meeting has since changed the way we look at markets. One of the equations to which you will be introduced in this book is: *Market Understanding + (Self-Understanding × Strategy) = Results*. Norman's specialty is Self-Understanding. Although he remains a member of both the Chicago Board of Trade and the Chicago Board Options Exchange, his primary focus is consulting businesses, schools, and families on tools for Self-Help. Norman resides in Wilmette, Illinois.

Donald Jones, president of CISCO, a Chicago-based research and database firm, has helped us in countless ways over the years. CISCO was the first database to begin providing the Market Profile and Liquidity Data Bank to the public. In addition to providing the data for many of the illustrations presented in these pages, Don has also taken the time on numerous occasions to share his ideas and analytical research.

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James F. Dalton
Eric T. Jones
Robert B. Dalton

Chapter 1

Introduction

Jim Kelvin was a retired cattle rancher from Texas. He had developed an interest in the futures market during the years when he would hedge his livestock at opportune prices. After he sold his ranching business, he began to experiment with a few small trades as a hobby.

Jim read everything he could find on futures trading. He studied all the technical models, read manual after manual on market analysis, attended seminars, and kept point and figure charts. In time, he felt he had a firm grasp on all the factors that make the market tick and began to look at trading as a serious vocation. He wasn't making money, but he thought he was just paying his dues as he learned the intricacies of his trading system.

One morning, Jim got up at 6:00, as he always did, and went to his study to turn on his quote monitors and prepare for the market's open. He picked up the *Wall Street Journal* to see what the bank traders and brokerage analysts were saying about the foreign exchange market. He had been watching the Japanese yen closely, because he felt the recent depth of coverage in the news would surely reveal some good trade opportunities. The U.S. dollar was expected to record new lows because of a slowing U.S. economy and consistently negative trade balances, forcing the yen and other currencies higher. All the foreign exchange related articles on his quote equipment news service were bullish for the yen.

A good friend and fellow trader called and commented on how the currencies should rally that day. Jim then checked the 24-day channel model and the 16- to 32-day moving average crossover model, two longer term technical indicators on which he frequently based his trading—both had been generating buy signals for some time.

Jim glanced over his charts and volume numbers and chewed on the end of a pencil. At the end of every day, he conducted a personal analysis of the market's structure and wrote down possible trades for the following day. Last night he had written “weakening yen—look for opportunity to sell.” The yen had been in an upward trend for some time, but in recent weeks volume was drying up. Price was moving higher, but activity was decreasing and there had been no substantial moves to the up side in over a week.

He knew from his ranching days that less volume was significant. When he would auction off his livestock, the price would continue up until the last buyer had bought. When the auction was nearing its end, the bulk of the buyers would have dropped out because they had fulfilled their inventory requirement or the price was too high. When no one was left to buy, the auction was over.

He read his analysis again. Common market sense told him that the up auction in the yen was over. There were no more buyers. But what about all the fundamental and technical indicators?

“All these professionals can't be wrong,” Jim said to himself. “I can't sell the yen.”

The market was going to open in less than five minutes. Jim stared at his blank monitor for a moment, thinking about what his friend had said. He put his hand on the phone, but did not pick it up.

The yen opened higher, rose a few ticks, and then stalled. The floor traders were acting on the recent bullish sentiment, but the buyers that had driven the yen up for the

past month were nowhere to be found. He just sat and watched his terminal. *It's going to break . . . I should sell*, he thought. The flashing green price on his quote screen began to drop as he sank deeper into his chair and indecision tightened its grip.

What happened? Jim Kelvin's decision-making process was jammed by the conflict between his own intuition and popular opinion. "How can the majority be wrong?"

The majority of people who trade futures don't make money. In fact, over 90 percent aren't successful enough to justify being in the market. If you trade with the majority, then you will fare only as well as the average, and the average market participant does not make money!

He was caught, like the goat that starves to death between two piles of hay, in the conflict of multiple sources of information indicating opposite conditions. Jim's common sense and firm understanding of the market's auction process told him the yen was weak and should have been sold, but he let himself become frozen by the power of the majority. All the fundamental and technical indicators agreed—everyone was predicting the bull trend to continue.

The difference is relatively simple. Jim was basing his opinion on current market information—he was "listening" to the evolving market—while all the other sources were based on information that was history and no longer relevant to what the market was doing *in the present tense*.

What if a baseball catcher waited to see how fast a man stealing second could run or pondered how often he was successful before he threw the ball? There is no way the throw would be in time. A good catcher operates solely in the present tense. He feels when the steal is on and reacts immediately, just as an experienced trader feels the direction of the market and reacts immediately.

Similarly, if a linebacker waited until he could see what the offense was doing or tried to read the play by watching the

scoreboard, he would never make the key tackle. He reads the offense by recognizing patterns learned from experience and by trusting his intuition—sensing the play. To wait is to miss the opportunity. If you wait until a market has committed itself in a direction, you are too late.

In *Mind Over Markets*, our goal is to teach you how to read the plays. In more concrete terms, you will learn how to identify the information generated by the market, understand its implications, and act on your knowledge. However, this is not a book about a trading system that works or does not work. The Market Profile is not a black box that dogmatically tells you when to buy and sell commodities. This is a book on learning. This is a book on observing and understanding the market.

Mind Over Markets is organized around the five basic steps in the learning process, roughly corresponding to the five stages of skill acquisition discussed in the book *Mind Over Machine*, by Hubert and Stuart Dreyfus.

To illustrate these stages, imagine a young man named David. He attends a concert at his college given by a well-known contemporary pianist. While listening to Beethoven's haunting "Moonlight Sonata," he is moved by the pure emotion expressed in the piece and decides he must learn to play the piano. The next day he arranges for his first lesson.

In the first few weeks, David learns to "recognize objective facts and features relevant to the skill and acquires rules for determining actions based on those facts and features."¹ In other words, he reaches the first stage of learning: *the novice*. He learns that the black ellipse with a stem is a note, and that a note placed on the bottom line of the treble staff is an E. He is shown where the E is on the keyboard and can then press the corresponding key to sound the note.

David can look at a sheet of music, and by reducing it into individual parts, he can find the right keys and play the song. Of course, this is a slow, painstaking process that forces listeners to use their imagination when trying to make out any semblance of melody.

After a month of lessons and regular practice, David becomes an *advanced beginner*. By playing a song over and over, he goes beyond the note-by-note struggle and begins to achieve some continuity of melody. Experience improves his performance. He still sees the song as a series of notes on a page, but begins to feel the flow that allows a recognizable song to emerge. David can play “Amazing Grace” so it actually sounds like “Amazing Grace” and not some array of notes in random rhythm.

As the years go by, David reaches the third level and becomes a *competent* pianist. Most musicians never pass this stage to become proficient or expert. He sees each song as a whole, a certain expression to be performed with a definite goal in mind. He still plays by reading the notes, but he achieves some degree of emotion and purpose in his playing.

An important distinction must be made here. David plays with the emotion of the written expression in the piece (crescendos and fortes, etc.), not with individual interpretation. He performs much like a machine that very accurately converts the musical score into a sonata or concerto.

This level of competency can lead to excellent performances, for most written music is thoroughly marked to show the composer's emotion. These marks have literal meaning, such as quiet (*pianissimo*), or pronounced and sharp (*staccato*). David plays Bach's “Prelude in E Minor” flawlessly at a recital and receives a standing ovation for his technical excellence.

However, David is still a person playing an instrument, much like a computer running a complicated flow chart. To advance to the next level, *proficiency*, he must transcend the physical notes on paper (the rules) and become deeply involved in the music.

To reach the fourth level and become proficient, David must learn the actual notes of a piece so well that he no longer has to think of them. The written work becomes a part of his mind, a holistic image, allowing him to interpret the music. This comes from experience—in life as well as hours of practice at the keyboard. The pianist must rely on his intuitive ability to express emotion through the piano, leaving behind the fact that the piece is in E flat in 6/8 time. Therefore, if David is proficient, he will feel the emotion that Bach created and, drawing on his own emotions and experience, convey that emotion in his playing.

Music that surpasses the competent level goes beyond the auditory aesthetic and involves the listeners. Hearing a proficient musician is often a deeply moving experience, for passionate music arises from the emotion of the performer and strikes similar chords in the listener. This cannot be explained in rational terms, for one cannot teach the expression of true emotion. Only through experience and involvement can proficiency be reached.

The final stage is labeled by Dreyfus and Dreyfus as *expertise*. David has studied piano for many years and knows the instrument inside and out. When he plays, the piano becomes an extension of his body. It is as if the music comes straight from his mind, which in an important way it does. He no longer thinks of individual notes or any rules when his hands are on the keyboard.

An expert musician feels the melody, and the song lives as an expression of his feeling. The mechanical aspects are fully ingrained, leaving the brain to its wonderful powers of creation. Listening to an expert musician is like peering into

his thoughts and feeling the weight of his sadness or the exhilaration of his joy. It is a mode of expression that transcends all rules and calculative rationality to become pure expression. Few people reach the expert level in any field.

This example was meant to introduce you to the basic levels of skill acquisition that we will attempt to take you through in learning to trade the futures market successfully. However, learning is a process that requires a great deal of time and effort, and learning to be an expert trader is no exception. The musician spends many hours of rote memorization and practice to develop experience and skill. Successful trading requires the same discipline and hard work.

Many perceive futures trading to be a glamorous, high-profit venture for those with the nerve to trade and that, through the purchase of mechanical systems and computer software, you can bypass the time and dedication it takes to succeed in other professions.

In reality, there are few glamorous professions. Some, like the music industry, reward the best quite impressively. It is easy for the naive music lover to glamorize performers like Burt Bacharach, Frank Sinatra, and Billy Joel. However, if we dig deep behind the sell-out stadium concerts and multiplatinum albums, the music business is not much different than any other profession. For every Simon and Garfunkel there are literally millions of aspiring young musicians who spend endless hours of dedication and frustration learning and perfecting their profession. Even the established superstars spent uncounted days perfecting each song and their musical ability to achieve recognition.

Because of the difficulty of making it big, many musicians burn out. The process of becoming good enough to succeed brings with it the potential for failure, and the process of becoming an expert trader is just as difficult. The learning in

this book goes beyond technical systems into areas of self-understanding that might reveal weakness in your abilities of self and market observation, discipline, and objectivity. Also, much of the information in this book differs from the accepted models of market analysis. Just as you will learn that the best trades fly in the face of the most recent market activity, the information in this book flies in the face of most current opinions and theories on trading and understanding the market.

Futures trading is not a glamorous or profitable experience for most of the people who attempt to trade. Futures trading is a profession, and it takes as much time and dedication to succeed as any other profession. You will start as a beginner, learning the objective basics about the Profile, then proceed through the stages toward the ultimate goal of any professional in any trade—becoming an expert.

Note

- [1.](#) Hubert Dreyfus and Stuart Dreyfus, *Mind Over Machine* (New York: The Free Press, 1986), pp. 21–36.

Chapter 2

Novice

Novice is the first stage in any process. No one starts out an expert, or even an advanced beginner. To learn any skill, you must begin by learning the necessary objective facts and features—the tools with which you will build your skill from the ground up. Just as a carpenter learns the function of a saw, hammer, and plane before attempting to make his first basic bird feeder, you must learn the mechanics of the Market Profile before you make your first basic market decisions.

The learning that occurs during the novice stage is largely rote memorization. The carpenter is taught the workings of his tools; the aspiring pianist is taught the definitions that form the base of all music theory. This learning comes from a derivative source, such as a book or a teacher, and does not involve the novice in any active way as he or she sits and listens or reads. Some degree of derivative learning is necessary, especially during the early stages, but in the words of the ancient Greek philosopher Heraclitus, “Much learning does not teach understanding.” Only through experience and extensive practice and application will understanding and expertise arise.

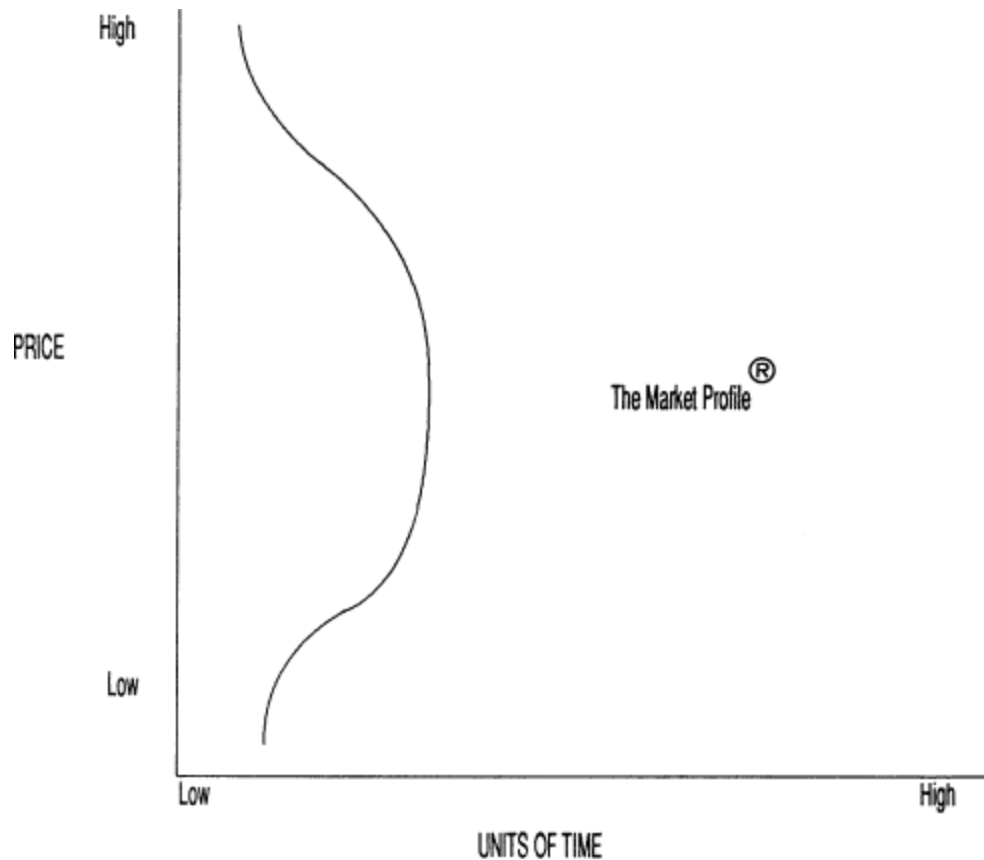
Throughout this book (a derivative source), there are many definitions and patterns to memorize. It is important to remember, however, that the information is only part of a larger whole that will develop as you read and attempt to assimilate what you have learned with your personality, individual trading style, and experience. Keep an open mind

and actively apply the new knowledge to your observations of the marketplace.

Perhaps some of your established beliefs have already been thrown into question. In the example at the beginning of the book, Jim the yen trader is torn between the different sources of information: fundamental, technical, and market generated. All the fundamental sources (newspapers, trade magazines, personal advice) and technical sources (channel models, moving averages, etc.) were predicting a rally in the foreign currencies. The market-generated information, which is the market's price activity recorded in relation to time in a study with statistical curve, was indicating a market that had reached the top of the up movement. This is not to say that all technical gurus, financial writers, and market analysts are useless—there is just no greater indication of what the market is doing than the market itself!

The Market Profile is a conduit for listening to the market. It is merely a graph that plots time on one axis and price on the other to give a visual impression of market activity. This representation takes the form of a statistical bell curve, just like your high school teacher used. Most students scored in the middle of the bell curve with Cs, while fewer received As and Fs. Similarly, the majority of a day's transactional volume takes place in a common range of prices, with less trading on the day's extremes (see [Figure 2.1](#)).

[Figure 2.1](#) A Statistical Bell Curve; the Organization of Price over Time



The Market Profile is simply a way of organizing market activity as it unfolds. It is not a system that predicts tops and bottoms or trend continuation any more than the teacher's grade chart is an indicator of overall student intelligence. The Market Profile is an evolving gauge that accurately reflects market activity in the present tense, a gauge being defined as a passive device that exists only to measure something. The key to the Market Profile lies in correctly reading this information.

The statistical bell curve is employed to allow us to visualize what a graph might look like that plots time, a constant, on the horizontal axis against price, a variable, on the vertical axis. Scientists have employed this method of analysis for generations. Its utilization in market analysis creates a distribution curve that allows us to organize the data and better understand the continuous two-way auction process. The graph of the Market Profile is seldom bell

shaped; there is, more often, a skew to the Profile. However, this fact does not detract from its value as a teaching tool to understand the foundational principle of the Market Profile.

Laying the Foundation

In this section, we will discuss the definitions and concepts that form the foundation for learning to understand the market through the Market Profile. As has been stated before, this is a challenging task. Everything you learn about the Market Profile is interrelated and integral to a complete understanding of the market. Each concept is like a piece in an intricate puzzle that should be studied to determine its place in the developing picture. If you file each piece away as a separately defined definition, you will be left with a jumble of seemingly unrelated facts. But, if you continually integrate each section of the book with what you have already learned, the picture will slowly emerge.

The Auction

Jim Kelvin intuitively knew that the bull trend in the yen was over because of his days in the ranching business. At first glance, the futures market seems to have very little to do with cattle ranching. However, they are both markets, and all markets share a common auction process through which trade is conducted.

As Jim Kelvin sat before his quote monitor on that morning, he recalled one of the last days he took his livestock to auction. Price for feeder cattle had been steadily climbing for several months, reaching a high of 86 cents, but the number of steers sold had fallen significantly during the previous week's auction. The meat processors had cut back their purchasing to the bare minimum at higher prices, buying just enough to keep their processing plants operating and to meet their contract obligations. Jim knew

that price would have to auction lower to find renewed buying.

A steer was led into the auction barn. The sale barn manager at one end of the circular corral called out the starting price, "Do I hear 80 cents for this fine feeder steer?" The opening call was too high and did not get a raise from the men standing around the perimeter of the circle. "78?...76?...Do I hear 74 cents?" Finally, a buyer entered the auction, starting the bidding at 72 cents. After a small rally as buyers called out their offers, the steer was sold at 76 cents a pound. The up auction over the last few months in the cattle market had ended. Price had to auction lower to attract buyers.

During some auctions there would be an immediate response to the opening bid, and price would move up quickly. "Do I hear 82? I have an offer for 82...Do I hear 84?...85?" as the men around the perimeter of the ring cried out their offers.

Other times, the initial price would be too high, and the auctioneer would quickly lower the bid, "Do I hear 78?...77?...76 for this fine steer?" The price would back off until a buyer entered the auction, then price would begin to move upward, often auctioning beyond the opening price. Once the auction got started, competition and anxiety among buyers sometimes drove the market beyond the prices that were initially rejected as too high. Price would continue up until only one buyer remained. "Ninety-two going once, twice, three times...sold," then the auction was over.

The futures market auctions in a similar manner. If the open is considered below value, price auctions higher in search of sellers. If the open is considered too high by the market's participants, price auctions lower, searching for buyers. Once a buyer enters the market, price begins to auction upward until the last buyer has bought. Similarly,