

STEIDLMEYER ON MARKETS

A New Approach to Trading

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Early Lessons

The most important element in becoming a successful trader is having a sound background from which to trade, consisting of a strong base of acquired knowledge derived from being active in the markets through time. Building this background is in some ways the easiest and in other ways the most difficult thing for a trader to accomplish. Trading experiences, observations of all kinds, a focus on what is most important and a clear understanding of business principles—all are necessary ingredients in a strong trading background. Awareness and patience are the requirements for developing it. Without a sound background, your trading cannot be consistently successful. With it, you can develop clear, correct ways of thinking and confidence in your trading judgment.

In today's fast-moving world, some traders try to bypass the crucial first step of developing a sound background, and then rationalize the lack of background for the rest of their careers. But the opportunity to develop the needed background is always there.

I'd like to share with you the background that underlies my own understanding of the markets. The experiences that went into building it are varied and demanded a lot of time and hard work. If you can learn the principles that these experiences illustrate, you'll find that the same prin-

principles figure in your own experiences as a trader. I think you'll also learn some things about today's markets.

TRUST AND FREEDOM

In my formative years, from 1944 until I completed high school in 1956, I gained both education and knowledge. Education provides a format and method for learning, but knowledge comes through experience. Thus, a lot of knowledge develops on a subconscious level. I was not aware of this subconscious learning process when I was growing up, but in later years I found that I had a large storehouse of knowledge to draw on in order to gain a good understanding of any subject. I had stored in my subconscious a data base of real knowledge that came from varied experiences.

I grew up on a ranch in California, where much of my early learning came from being exposed to the family business. Skill was greatly respected in my family, but more important than skill was integrity. A person who was disloyal, dishonest or untrustworthy wasn't needed, no matter how skilled he might be. If someone my family was doing business with turned out to be untrustworthy, we stopped doing business with him, no matter how rewarding the deal might appear to be on an immediate basis. We used this principle to avoid major losses in the future, and I stick by this principle to this day.

In my family, no one was condemned for making mistakes. We understood that all knowledge came from making mistakes. This idea became dominant as I ventured out into the world and got bumped occasionally. "That was a good experience," my parents would say. "Learn from it

and go forward." My parents didn't criticize or analyze the mistakes we boys made. We did that on our own. The burden of facing up to our mistakes and learning from each experience was on our shoulders, no one else's.

Patience was always stressed because it reflected and developed our inner self-confidence. We weren't expected to show quick results; it was understood that "Slow and steady wins the race." My parents encouraged me to take my time to find a field that I enjoyed rather than one they would like me to pursue. The object was to do things and to find out what I could and couldn't do — then I'd be able to make choices for the future.

Later I learned about the American Indian practice of putting a young man of eleven or twelve years old out alone on a mountaintop or in the desert to spend several days searching for the meaning of his life. The revelation might come through a sign, or perhaps through a dream; either might reveal the young man's destined path. I was raised in the same spirit, and it has become an important part of my background as a trader. Today I enjoy the same freedom to search and continually reevaluate my life's goals.

Home was a base from which we could venture and a sanctuary to which we could always return. My parents assured us that we would always be welcome to stay with them no matter how bad things were. But we were responsible to ourselves, to those surrounding us and to the community. If we ever violated that trust, we might lose our sanctuary.

Success was viewed as temporary. We were encouraged not to get too excited when things went well or too depressed when things didn't, but to remain emotionally in balance. Time was the most important measurement of all. A person or an idea had to stand the test of time. New ideas and dreams were not disregarded, even if they didn't

work out. They were considered opportunities for learning and growth.

THE IMPORTANCE OF FIXING THE GATE

When I worked for my father, I learned not to run away from a problem and to finish what I started. Our philosophy was to do the Job once, and do it right; then move on to the next one. My father never understood why people would fall to recognize a problem or, if they did, why they wouldn't deal with it until forced to do so. We had many wooden gates on our ranch, and from time to time they would need repair. When our ranch hands went through a broken gate, they would open and close it without stopping to fix it. By contrast, my father would fix the gate then and there. That was his way.

Years later, when the markets changed in 1969, the trading method I had developed no longer worked—it was "broken." Although I was trading in the markets every day, I didn't want to face the reality of the broken gate. Once I realized that I was running away from the problem, just as the ranch hands had ignored the broken gate, I motivated myself to stop and correct the problem.

I also learned from my father the importance of the last 10 percent of any Job. He always said that this was the most important part of any task—the part that required the greatest discipline. This final effort separates success from failure; it separates the person who always has ten projects 90 percent done from the person who successfully finishes each task; it separates the many climbers who reach the 25,000-foot level on Everest from the few who reach the summit. The same philosophy applies to trading. The

willingness to follow through on a task marks the difference between those who are almost successful and those who achieve their goals.

In my family, we also learned to recognize the abilities of others. Some people always have more talent than you, some less. Don't compete outside yourself; try to be the best you can within your own abilities. But learn from observing yourself and the many types of people around you.

THE SECRETS OF ORDER AND CONTROL

In August 1946, when I was seven years old, my father and I were moving a tractor from our valley ranch to our ranch in Nevada. As we reached the foothills around four in the afternoon, about four hours from our destination, we got a flat tire and stopped at a tire shop in Orville, California.

In those days, truck tires were complicated to take apart and put back together, so at about ten to five they were still working on it. My father was anxious to get on with the trip. The mechanic wanted to quit work at five, so both men wanted to get the Job done. I watched them take the tire apart trying to put it together again and again, emotionally beating at the tire with a hammer and swearing at it. Finally, I piped up, "Why don't you put the tire back together the opposite way you took it apart?"

I can still see the mechanic's face as he turned his head toward me—his face covered with dirt and sweat—and said, "Well, how is that, sonny?" I proceeded to tell him how, and five minutes later we were on our way.

I learned that by watching you can perceive a sense of order. Emotions and impatience don't produce results; observation and understanding do. I've found the same to be true in trading.

When working the land, there was pride in the different chores we were given. A Job had to be done according to Standards that were acceptable to our parents and to the ranch. More importantly, it had to meet our own Standards first, before we even showed anyone the completed Job. In my family, your Job was you—a reflection of your Standards.

The full-time ranch workers did a good Job with the cash-flow crops, but not as well with the fill-in Jobs, which kept them occupied during slack times. One of these Jobs was irrigating the back pasture. The back pasture wasn't levelled, so you couldn't get water across it. If you were irrigating a bean or a corn crop, which was planted on level ground, you were expected to make sure water got over every inch. But everybody slacked off on the fill-in Jobs because no one ever checked them.

But when I was asked to irrigate the back pasture, I designed a system of dams to get water all over the field, which had never before been fully irrigated. No one ever knew, but that didn't matter; I got personal satisfaction out of doing it. I realized that if I stayed within the accepted Standards for the Job, I wouldn't learn anything. By stretching myself beyond the Standards, forcing myself to do more, I learned a lot.

Another experience taught me to have confidence in my abilities and to take control of a Situation. I was riding with our dogs on the back edge of a trailer that my dad was pulling behind the pickup truck. We were moving down a rugged road at about 25 miles an hour. Suddenly, the trailer hit a bumpy Stretch of the road, and I realized that

I couldn't hang on because there was no place to grip on the back of the trailer. I pictured myself falling off the truck onto the rocky road. I could see that if I feil, I would probably break my arms and possibly die. I panicked. I started to scream, and the dogs began to bark, but my dad couldn't hear over the noise of the pickup and the rattle of the bounding trailer.

Fortunately, I figured out a way to avoid disaster. By lifting my body off the truck with my arms and tilting my weight back towards my head, I was able to absorb the bounce in my arms and keep my balance. I rode that way for about three-quarters of a mile, until we got to the shop. I never told my father about this experience, although I'd been really scared by it. I learned not to accept disaster. In this episode I fought off disaster with my brains and my muscles and I gained confidence in my own abilities as a result.

LOOKING BEYOND THE SELF

One Saturday, when I was about eleven, I wanted to hunt ducks. It was a rainy day with a strong south wind, and there were ducks and geese all over the ranch. My brothers and I had to move about 1,500 sheep from one ranch to another before I could go hunting. My father warned me not to cut across the fields with the sheep. But as we proceeded, I grew more and more anxious to go hunting because we were passing right by the ducks and geese.

Finally, I told my brothers that we should take the sheep across the field to get to the other ranch faster. As we approached the middle of the field, about 150 sheep got stuck in the mud. Now, if you can image a sheep up to

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her belly in mud, with her wool full of mud—each weighing more than I did—and multiply that by 150, you can imagine what we were dealing with.

All the ranch hands got off at noon on Saturdays, but not that week. Everyone worked until 3 P.M. that day, pulling sheep out of the mud—I was too small to move them myself. No one complained, but I realized that my selfish interest had given a lot of people a lot of extra work. From that experience I learned not to put myself first.

To me, success in trading also requires unselfishness. When you're in the pit, you have an Obligation to other traders and brokers in the pit to contribute to the well-being of the marketplace, not just to seek your own profit. The marketplace comes before you or any other individual trader.

GLIMPSES OF MARKETS AT WORK

Observing the ranch hands trading in used guns and cars and my father trading in land, equipment, and crop markets taught me to take advantage of situations rather than letting them take advantage of me. At harvest time, my father wasn't speculating for big gains. He wanted a fair price for his crop in order to make a normal profit for his work and his capital investment. If the price at harvest time was fair, he sold; if not, he held and stored the grain.

When buying, my father wanted a fair price as well. I remember going with my father shopping to buy all the groceries for the camp. He knew the price of everything, and he always bought sale items. If the price was too high he wouldn't buy; he would substitute or go without. He had a list of what he thought each item should cost, and

he'd check off the list when he got to the counter to make sure they didn't make any mistakes in adding up the bill.

When my father had the Option of buying some used farm equipment, he behaved just as the ranch workers did when they were buying a used car. If the car was undervalued, they would buy it; if it was overvalued, they wouldn't. At the cattle sales, my father would say, "You can make a lot of money just being a sharp buyer. But if you overpay, there's no way to get it back." I learned that if you buy something over value, time is against you; but if you underpay, time is on your side. This became the underpinning of my approach to trading commodities.

My father had one rule in buying property: six months or a year after you buy the property, your neighbor should be willing to pay what you paid for it. That was his measurement of value. He was an optimistic man, but one imprinted by the experience of the Depression. Although he went out of his way to avoid debt, he could see that in the postwar world values were changing, making it necessary to use debt judiciously. He knew that the focus of the ranch should not be on daily operations, but on land acquisitions. So he would never borrow to finance daily operations, but he would use credit to buy land.

In buying property, my father had different time frames, different needs and different motives, depending on the Situation. He once planned to buy a ranch with his brothers at an auction. It was a sealed bid auction, at which everybody had the right to raise the bid 10 percent. On our way to the auction, he told me that the other people there would have more money than he did, and that he would have to scare them out of the trade if he hoped to get the land. To do so, he bid a lot higher than what people thought the land was worth, so that there wouldn't be any after-auction rebids.

When his bid was announced, a hush fell over the crowd. Many of the Farmers in the area told my father that they would sell him their land at that price. No one else tried to raise the bid, and my father accomplished his goal.

This is one thing that a good broker or trader does. Many times they use a higher than normal price to attract traders, realizing that in the short term they were overpaying; but within a half hour or an hour, that price would be a good one.

In another instance, my father acquired a piece of property by playing a waiting game. He felt that nobody else was going to buy the property, so he had plenty of time. The attorney for the estate dickered over the price for a year and a half, but my father knew that the estate had to sell it. He gambled on the chance that no one else would buy it, and he won. He got the property for about 40 percent less than the original asking price. Again, the relationship of market conditions to value and to the buyer's and seller's needs was critical.

The point is this: My father was always prepared, and he always had a game plan. When he started ranching back in 1916, he knew what he was going to buy and how he was going to accomplish his plan; and he had the patience to do it over time. He knew when to move quickly and when to move slowly. I was always after him to buy other pieces of property that were outside his game plan. But he never would. He always refused to buy marginal properties because he felt that he should never buy anything bad or sell anything good.

My father explained these ideas to me, and although I had had no previous market experiences of my own, I began to see the difference between buying a used car, buying a gun, buying a piece of land or selling crops. These were all different markets, and depending on the needs of

the individual, there were different ways to approach each market applying the same principles of value to different conditions.

There was a wool buyer who came up from Stockton, California to buy the tag ends of the pelts and the wool that wasn't sold at shearing. My father noticed that every time the buyer came up, the wool market would pick up. He asked the wool buyer about this, and Mr. S. explained, "That's what I'm in business for." This was the first inkling I had that markets could be read and understood.

My father was aware that Mr. S. had a deadline from which he was operating. The wool market was active only a couple of times a year. If my father didn't sell his wool to Mr. S. within the deadline, he would miss the opportunity to sell. He also noticed that the frequency of Mr. S.'s phone calls and visits would increase as his deadline approached.

My father used to trap skunks and raccoons along the river, dry the pelts, and sell them for Christmas money. Mr. S. would come up to our ranch in November and pay a big price for these ratty pelts, as a loss leader to get my dad in a good mood. He would also make a low offer for the wool to be sheared later in the year. My dad would naturally refuse to sell the wool at this low price.

Mr. S. would call again in a month or so with a higher price and would continue to call more and more frequently until the deal was struck. I watched my father play his different prices and frequency of contact off against the deadline for selling the wool in an active market. In this way, an amicable deal in which both people made money was eventually struck. In fact, my father always said that both sides had to make money for any deal to succeed.

Whenever my father sold wool, cattle, sheep or any other commodity, he felt that the information about the sale was

between him and the buyer, and that others who might be interested had no right to the Information. So I learned early that transactional data is more important Information in any market than nominal quotes. (Nominal quotes are bid and offer prices, representing the general parameters of what a price could be, not necessarily confirmed by an actual transaction. Data from a real transaction is much more meaningful.) By being active in the marketplace, you gain Information. This has held true throughout my trading career. The more active I am as a trader, the more information I have in my hand.

My only business deal involving land occurred when I was sixteen. My mother had ten acres on the outskirts of Colusa, California, on which a normal farming profit would be about \$20 an acre per year. But the parcel was too small to be worth farming.

A Company with a contract to run a powerline across the valley wanted this high ground next to Highway 20 as a storage area for its trucks, towers, and equipment because much of the rest of the county was flooded with water in the winter. They offered us \$75 rental for one acre of the parcel for a year. My mother thought that was a good offer, but I said I could get her \$1,000. I remember my dad saying, "It's your choice, Mother. You can take a sure \$75, or you can take Pete's promise of \$1,000."

The next day, my mother decided to go with me. I met the power Company representative in the afternoon and told him what we got for similar properties. I explained that there were fairgrounds across from the property and that if we rented it to his Company, we wouldn't be able to get the parking revenues we usually received. This was a slight exaggeration. A fair was held every year across the road, and people did park on our property at that time,

but we had never received any payment for this. To compensate, we wanted \$1,000 for the acre.

The representative said he would talk to his home office and let us know. Three or four days later, he accepted the deal. I felt that I had done a good job and created a deal that was fair to both sides. The power Company ended up staying for three years; my mother made \$3,000 instead of \$225, and I got a 5 percent commission.

To my father, \$75 cash represented real value, while I could see that the value of the land to the power Company representative far exceeded \$1,000. He needed to be close to the road and to be able to use the high property while the rest of the county was flooded in the winter. So the market worked in this case to find a fair price. It moved up quickly from \$75 to \$1,000 because it was way undervalued at \$75.

It also may have been undervalued at \$1,000; we don't know because there was no other comparable reference point. I didn't ask a price high enough to evoke a lower counteroffer. So to this day we don't know for sure whether the \$1,000 price was really a good deal or not. I was satisfied at the time, but maybe I could have done better.

My father believed that it's very difficult to get ahead and be successful. He always said that the main thing is to be consistently good over a long period of time. Play the compound interest game; build your base slowly and surely. A small increase on a big base is better than a big move on no base.

The key in business is to make sure that you win in the long run and that you can sustain yourself on the down side. If you can handle the downs, you'll always be successful—that was my father's theory. This same principle has worked as part of my trading strategy.

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My mother was more of a general guide for me. She would say, "Go out and do things. You can't learn without experience." Her point was that when you go beyond your knowledge base, you're not going to be successful immediately, but you will gain experience that expands your base and ultimately propels you forward.

I came to realize that, like everyone else, I was surrounded by a big bubble that kept me close to my family, my economic base and my community. I became convinced that I had to move outside that bubble to be successful. I respected my community and its values, but I had to set myself apart from the goals and aspirations of others. This realization set the stage for the next phase of my development.

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College Years

In 1957, I decided to go to College. I wanted to break with the strong social tradition that you had to go to College to do things. But I finally enrolled as an accounting major in the University of California at Berkeley because I wanted to see for myself what College was like. I already knew that I wasn't going to work for anybody else, and that the grades I got in school weren't going to make much difference to me; I just wanted the experience of College. If I found that there was no benefit there for me, I wasn't going to stay. As far as I was concerned there would be no stigma about leaving.

THE MARKETS BECKON

My first awareness of any organized markets came at Berkeley during 1957 and 1958. There was a recession in the economy, but stock prices were rallying. Friends of mine were doing quite well with their stock holdings, and I became intrigued and started to watch the market. I noticed the contrast between economic forecasts and what actually happened.

I believe it was in the spring of 1958 that an article appeared in *Fortune* magazine about a father and son team

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of commodity traders. They started out with \$10,000 and made more than a million trading through Merrill Lynch, before losing almost all of it and ending up with a twenty-five or thirty thousand dollar profit after commissions. I was amazed that so much money could be made in a short time from such a small starting base, so I began to read about the commodity markets, follow them and ask people about them.

I got recommendations on trading corn, wheat, soybeans and soybean oil from various brokerage houses. I started trading, but I was unsuccessful. In fact, I inherited \$500 from my grandfather, who died at the age of 99, and I lost it all in one day. That was sobering. It took my grandfather 99 years to save that money, and I blew it in a day. Fortunately, I didn't have any more money to lose. In fact, in all my early learning experiences, my trading stake was never more than five or six hundred dollars. So this part of my education wasn't expensive.

During the summer of 1958, my father and my uncles decided that my cousins and I could farm some double-crop land (wheat followed by beans) and use the earnings to fund our College educations. I had a dream that by planting the crop at the end of June and harvesting it in October I was going to make \$25,000. To do this, everything had to work perfectly—I'd need a big crop and a high price.

As the summer progressed, I kept refiguring my expenses and my revenues, and I kept lowering my expected profit—down to \$15,000, and \$10,000. When I figured that it was only \$6,000, I harvested the beans and got a roadside bid of 10 cents a pound. I laughed at the bid and said that I wanted 17 cents, the price beans had traded at the year before. Instead, I watched as the price went from 10.25 to 10 to 9.75, and so on, down in 25-cent increments to 6.50 in December. Only because I had had a good yield

could the 6.50 price allow me to repay my bank loan. I ended up with nothing for myself.

After I sold the beans at 6.50, I watched them go up to about 14 by the following April or May. I was very fortunate that I hadn't had much money to lose. I'd been able to stop my losses at zero, which a lot of people in the commodities business can't do.

Many commodity traders go through experiences like the one I had that summer. My plan had been based on a totally unrealistic idea—a set of dreams and hopes rather than facts. When a trade is developed this way, you are generally forced to exit it at the bottom of the move, and you are unable to take advantage of any price rise that follows. Your trade may really have been right, but you lacked the knowledge, experience and discipline to pull it off.

DISCOVERING THE BELL CURVE

I had my first awakening in the spring of 1958, when I took a statistics course at Berkeley and was introduced to the concept of the bell curve. I still remember the page of the textbook where it said that through the bell curve, out of apparent chaos comes a beautiful cosmic order. This hit home because I knew that my trading observations and experiences up to this time lacked a sense of order. I began trying to visualize the organization of the seemingly chaotic activity in the commodity pits—the chaos that everyone else accepted unquestioningly—within the structure of the bell curve. My job, I decided, would be to find a way to bring order to that chaos, and the bell curve, I sensed, would be the way.

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At this point, the idea remained simply an image, with no hard work or evidence to back it up. But it remained in the back of my mind for some time, waiting to be developed.

My personal trading had moved from being based on wire house recommendations to newsletter recommendations. Although both good and bad recommendations were available, I fell into the common trap of following the bad recommendations and being afraid to take the good ones. So I realized that I couldn't just buy a trading program from a wire house or a newsletter; I had to create my own trading program.

After about a year and a half at Berkeley, I decided that I had learned all I could in College, yet I wanted my degree. I felt that I had a natural bent toward trading, and I enjoyed it, but what I was learning in school wouldn't be directly relevant to my career as a commodities trader. But when I realized that I could acquire a learning process with which I could go forward and gain experience that would ultimately produce knowledge, I began to look at school in a different light. So after my sophomore year, I decided to give Berkeley one more year, and I doubled up on all my units so as to finish my program within that time.

During the summer of 1959, I took a finance course that introduced me to the principles of value investing through the classic work of Graham and Dodd. Their book, *Security Analysis*, made a lot of sense to me because I had already learned from observation and from talking with my father that, in any market, the relationship between price and value was the key—that price away from value always represented opportunity. I made the immediate association of using the bell curve to find value in the marketplace, although I still didn't see how I was going to do this. But I

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did feel that a merging of the bell curve with Graham and Dodd would provide a sound basis from which to approach the market.

JOHN SCHULTZ AND THE MINIMUM TREND

Now I had entered a new phase of my trading career, in which I realized that I had to broaden my knowledge base if I hoped to be successful. So I went out and bought every book I could find about commodity trading, markets, Stocks and successful traders. I tried to glean from these books a program whereby I could see what was happening in the markets. I began to realize that although the people I was reading about had different approaches and different styles, they must all be trying to do the same thing because they were all unsuccessful. After all, almost 90 percent of the people in the commodity markets lost. Commodity markets were not recommended for anybody.

So what was the common thread running through the books? The diagrams were really beautiful, but they were all trying to predict the market, and that was the problem. Graham and Dodd had opened my eyes to value. They had explained that value could be seen in the *present* tense rather than on a predictive basis; that you could understand the present by laying out all the conditions that currently prevailed and then note the changes that took place.

One of the best books I read at this time was a short dissertation called *A Treatise on Charting* by John Schultz. (It was self-published and is no longer available.) In reading this book, everything came together for me. I realized that there was a lot of potential in the marketplace and that, to take advantage of it, I had to have a way of making

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decisions. I had to know what I was doing, why I was doing it, and under what conditions I was doing it. Then I would be able to see and Interpret changes as they happened. That was the beginning of my formulation of a plan for trading.

I spent Christmas vacation in 1959 on a tractor, plowing a 500-acre field on the family ranch. As I completed more and more of the field, I watched the pattern of furrows being created in the field as the irregular shape of the unplowed portion grew smaller and smaller. At the same time, I was thinking about my commodity trading experiences, the books I had been reading and the ideas I had gotten from my education. The focus of all this was John Schultz's book on charting. At the end of his treatise, Schultz had written, "The best idea is still out there." As I plowed and thought, I gradually realized, "I'm the one who's got it."

The key idea on which I seized was Schultz's concept of the minimum trend. Schultz defined the minimum trend as the smallest unit of market activity. The advantage of this concept was that the minimum trend was one-sided: it could only get bigger, never smaller. The simplicity of this attracted me.

I decided to use a three-minute price range as my version of the minimum trend. The next step was realizing that a number of minimum trends could be grouped statistically to form a bell curve. I came up with the idea that the bell curve could be used to represent an arrangement of behavior around price. The first Standard deviation—the middle of the bell curve, where the majority of activity takes place—would represent value, while the second and third Standard deviations would measure price away from value. Whenever the market moved away from value, I would take the opposite side of the trade. Thus, for the

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first time, I would have a reason for making trading decisions—a reference point for trading. And although this idea wasn't fully developed at the time, I want to explain it further now because it proved to be so important.

CHARTING THE MINIMUM TREND

The commodity markets at the time were more responsive and less volatile than now, so this idea started at the right time and in the right place. (Responsive markets are those in which people are attracted to buy at lower prices and sell at higher prices. This is in contrast to markets in which people tend to buy higher prices and sell lower prices, which became more prevalent in the 1970s). As you'll see, the method I developed was especially well suited to responsive markets.

What I worked out, without understanding it, was a way of charting trading volume. The underlying formula is simple:

$$\text{Price} + \text{Time} = \text{Volume}$$

The three-minute minimum trend chart I developed was really a chart of people using, or not using, various price areas of the market. These minimum trend units, I found, would form a bell curve, looking something like Figure 2-1. As you can see, Figure 2-1 is a perfect example of the so-called normal distribution of price/time usage in the market—a perfect bell curve. This is the form responsive markets took, and still take today. If you look at a volume profile of any responsive market of today, you'll find a symmetrical pattern of much the same sort. Figure 2-2 is an example.

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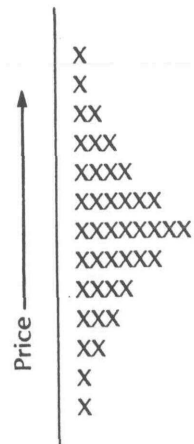


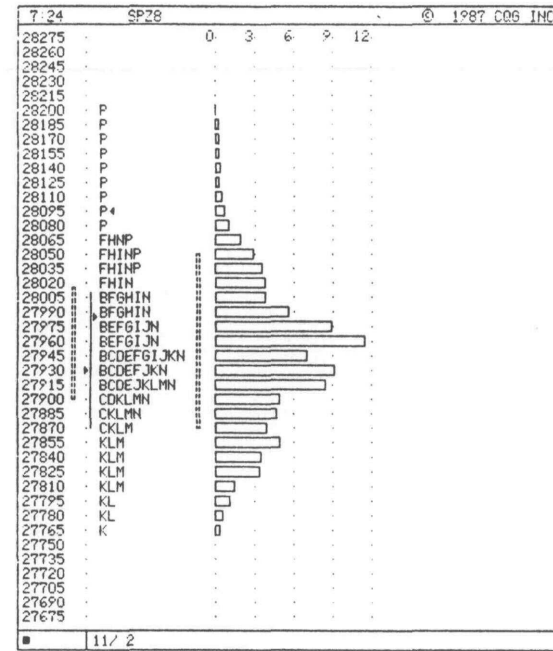
Figure 2-1. A sample minimum trend price/time chart.

As a trader, I was basically playing for this symmetrical pattern to develop, using the number of minimum trends at each price level as a timing device. I would play for the high-volume price to be at or close to the middle of the price range. Of course, the commodities markets were very different in the 1960s from now. They moved very slowly; the market might take a week or ten days to complete what we now consider to be a very small distribution. A trader could fade or go against a higher or lower opening in any market, and this strategy would work about 95 percent of the time—again reflecting the responsive nature of the markets. So my simple strategies worked well—much better than the same strategies would work today.

To illustrate my trading technique in the 1960s: Suppose we had a half-completed distribution at the end of a trading day. The minimum trend profile might look like Figure 2-3.

Suppose the market opened the next day a half-cent lower, at 261. I would be a buyer of the market, knowing

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Figure 2-2. Volume profile, S&P Index Futures. Note the almost perfectly symmetrical pattern of volume bars, with the high-volume price near the exact center of the range.

that the market was unbalanced and must come to balance in a responsive Situation. So I would be basically counting the number of minimum trends at each price and playing the fill-in, knowing that when the bell curve was completely filled in, I would be out of time at each price. Thus, I was using time rather than price as the key factor in my trading.

Figure 2-4 shows the second day's activity, following that of Figure 2-3. The O's represent the minimum trends on Day 2. Just by counting them and looking for the comple-

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| | |
|---------|----------|
| 262 1/8 | |
| 262 | X |
| 261 7/8 | XXX |
| 261 3/4 | XXXX |
| 261 5/8 | XXXXXX |
| 261 1/2 | XXXXXXXX |
| 261 3/8 | |
| 261 1/4 | |
| 261 1/8 | |
| 261 | |
| 260 7/8 | |

Figure 2-3. A minimum trend time/price chart, showing a partially completed distribution

tion of the bell curve (in both X's and O's), I could see when I was running out of time at a given price.

Having developed this method, I had accomplished my first objective in trading. I could now understand where price was and the conditions surrounding price, in the present tense.

THE MARKETS-SOLVED?

I was very excited about my discovery, and I called an older friend of mine, a well-respected trader. When I announced that I had "solved the markets," he said that this was ridiculous. At first, I was taken aback. But I thought about it and decided that my friend probably had a good deal of frustration in his life as a trader, and for that reason could not accept the fact that I had solved the markets. All this, however, was based only on theory. So I decided that, as soon as I could, I would try to put my ideas into practice.

College Years

I was thinking about the marketplace at the Chicago Board of Trade (CBOT) as a place to convert my ideas into opportunities—a forum for marketing my ideas. I knew that in real estate or any other business I couldn't just knock on doors and make deals, even if I was willing to pay a good price or sell cheap, because no one would be interested; there would be no liquidity in the marketplace for my projects. At the CBOT, however, I could market my ideas right in the pit. There would always be someone to take the opposite side of a transaction; and then the right thinking would win.

During 1960 I served in the U.S. Army, and, throughout my time in the Service and immediately after my discharge, I always had the commodity markets in mind. I had previously wanted to do something in agriculture, but opportunities there seemed closed because it was a high-capital, low-margin game. By contrast, I felt I could trade with a low-capital, high-ability strategy. So the CBOT seemed like the place for me. Although I had the educational background, the ideas and the desire to go forward,

| | |
|---------|----------|
| 262 1/8 | |
| 262 | X |
| 261 7/8 | XXX |
| 261 3/4 | XXXX |
| 261 5/8 | XXXXXX |
| 261 1/2 | XXXXXXXX |
| 261 3/8 | OOOOOO |
| 261 1/4 | OOOO |
| 261 1/8 | OOO |
| 261 | O |
| 260 7/8 | |

Figure 2-4. Minimum trend time/price chart for Day 2, showing the completed distribution in the form of a symmetrical bell curve.

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I still lacked the confidence, the courage and the capital to get started.

So I stumbled around for about six months after getting out of the service. My father would clip Job ads from the paper for me and tell me that I shouldn't be "too proud" to work for someone else. But I just kept on doing what I wanted to do—trying to put together real estate deals, trying different things. I was still sorting things out and looking for a direction in my life.

3

Chicago

In January 1962, I decided to go to Chicago to see what was there. I didn't know where I was going; I didn't know where LaSalle Street was; I didn't know where the Board of Trade building was; I didn't know anybody in Chicago—but I was going.

FALSE START

I said goodbye to my parents and arrived in Chicago on a cold, miserable day in February. There was snow in the streets, and it was black with coal dust. It wasn't very appealing to a young man from California.

I went straight to the Board of Trade and proceeded up to the balcony overlooking the trading floor. My hope for market liquidity disintegrated. Down below were a bunch of empty pits. There were about six people standing in the soybean pit, and there was no activity—no runners, no phones ringing, nothing going on. I decided to go back to California.

Back in California, I worked on my brother-in-law's farm and helped my father around the ranch. But I spent most of my time dreaming up real estate deals, trying to put packages and deals together, knocking on doors and getting

turned down. I thought my business ideas were sound, but people didn't like them. I was constantly scheming up deals that would allow me to make money without money, but no one was willing to fill in the other side of the equation. Nevertheless, I was confident something was going to happen.

A good Situation was developing in soybeans in the spring of 1963. A short crop and a dry planting season brought on a pretty good price move up—about 30 cents a bushel. At this point I was trading the minimum trend, although I hadn't developed a charting method yet. Instead, I was just visualizing prices and using my mental images as a guide. I caught most of the up move in soybeans and got out near the high. When the market went back down, I repurchased and got out when they went back up again. I felt really good about this because it reinforced my idea of grouping prices and then trying to buy or sell prices outside of value.

This little bit of experience gave me the confidence to go back to Chicago. I told a friend of mine, who was also my broker, what I was planning to do, and he decided to go out there with me. This was in the fall of 1963.

BREAKING IN

As I left for Chicago, I had all my money in the soybean market despite the fact that my father was advising me to "start fresh." I was long 100,000 beans with 17 cents profit. I was sure they'd go up a dollar, and I'd make \$100,000.

I wish I had listened to my father. I left for Chicago on Thursday, and by Friday soybeans were down the limit; they were supposed to be down another 7 cents on Mon-

day. When I got out, all my profit and all my capital had vanished.

So there I was, starting out in Chicago with no money, no friends and not much to go on. I was staying at the Fort Dearborn Hotel for \$1.50 a night. I would wake up crying in the morning, thinking about the great opportunity I'd lost because of my mismanagement and impatience.

I was able to borrow some money from the Bank of America in California to buy my membership on the Chicago Board of Trade, and I was approved by the CBOT membership committee on October 23, 1963.

At first, I was self-conscious about trading with open outcry, so I would just stand on the edge of the pit and keep track of minimum trends and groupings on trends on paper. Everybody thought I was a conventional chartist. In fact, when I went to pay my membership fees, the secretary of the exchange said to me, "I understand you use those charts. We've had a lot of people come and go with those things."

I turned to him and said, "Well, if you knew so much, you wouldn't be secretary of the exchange. You'd be down there trading."

At first, he was taken aback by my brashness. But he respected my candor, and he eventually became a lifelong friend.

My approach to trading remained the same: I had to have a reason to buy or sell, and I would be right or wrong based on that reason. If I was consistently wrong, I would have to do the opposite of what the indicator told me. But I had confidence in my ability to read and understand the market, even with no experience.

One afternoon, I was invited out for lunch by two acquaintances, one a member of the CBOT board of directors and the other a member of the New York Stock Exchange.

When we finished lunch, they asked me what I thought about the market. I told them I was taking very small positions because I wanted to "build my factory." In other words, I wanted to be able to make a series of small trades and come out with a profit; after building a base in this way, I would up my volume.

At this point, I was basically testing my decision-making process. I wanted to take the input from the market and use it to come out with a profit; so I made a lot of trades. I was basically a position trader, in that I usually held my positions all day or for several days.

I attribute my early success to the character of the market at the time. In the early 1960s, the market was both active and responsive, which allowed my basic game plan to work. I came in with a simple program of buying low and selling high. I figured that if I bought low and it stayed low, I'd get out; and if I sold high and it stayed high, I'd get out. The commodity markets weren't very volatile then; soybeans would move maybe a dollar in a really big move. Generally, everything else moved about 10 or 15 cents a bushel all year long. Today, we get moves of that size in 15 minutes.

Getting back to my story: both of the men I was having lunch with—experienced traders—had positions opposite me at the end of that day. I was worried that I might be doing something wrong because these men were obviously very successful.

The next morning, I considered getting out of my positions right away, but I decided to give them a little time. Within a couple of hours, the markets went my way. I knew then that, although I didn't have as much experience or direct knowledge as the other people in the market, I had a good sense of how the market was organized, and I was on the road to becoming a very successful trader.

SUCCESS IN A RESPONSIVE MARKET

I was firmly convinced that I had the best idea out there. I was going to measure the market in terms of time, and I was going to measure market conditions in the present tense. In an uncertain market, it is hard to predict with better than a fifty fifty shot. So rather than predicting, the idea is to try to understand current market conditions. As Graham and Dodd had shown, the value of a stock is determined by underlying conditions. If conditions change, value changes. But if the market is inherently strong, no blow can break it.

I found it very useful to spend my afternoons studying my purchase and sale sheet from the previous day to see whether I had been reacting properly or failing to take advantage of the full potential of my trades. I used this as an opportunity for critical self-analysis. I might say, "I bought soybeans right at the low today, but I took only a quarter of a cent profit. What did I do wrong?" This practice of self-analysis became a key element in what I called my equation of results:

Market Understanding X You = Results

In my first year of trading, I found out several key things that played a major role in the development of my theory of markets. I did this without any research; it came from experience and observation. While gaining trading experience, I was also learning how markets work and how to read them.

One belief I've always had is that young people adapt to situations very well. Like seeds in a greenhouse, they grow to fit their environment; but when stress comes—when the temperature changes within the greenhouse or the roof falls in—they have to make an adjustment. Seven or eight years usually pass before that happens to a young

trader just coming on the floor. I was lucky to start out in a responsive market with a responsive trading program. I don't know whether I would have survived in an initiating-style trading market.

Let's digress for a moment to explain how responsive and initiating markets differ. Initiating activity is the opposite of responsive activity. In general, in initiating activity, higher prices away from value attract buying, which produces further upward market movement; on the other hand, lower prices attract selling, which produces further downward movement. In responsive activity, the opposite is true: higher prices attract selling, while lower prices attract buying. In essence, responsive activity means that the market has found a fair price to distribute around, while initiating activity means that the market is seeking a fair price in a new distribution.

Figure 3-1 illustrates what initiating activity looks like. The market doesn't remain in Distribution 1, as it would in a responsive market; instead, it moves to a new distribution which is unknown until it finds a new, lower fair price to distribute around.

When I first came to Chicago, we had very few initiating days, but when they did occur, I always lost money. I could see this because my minimum trends showed an imbalance. I would get hurt on such days because I would anticipate when the market was going to change. My basic style was not to go *with* the market, but to go against it.

LEARNING BY OBSERVATION

Because I didn't know anybody in the pit, I developed the habit of observing closely the people around me. I was

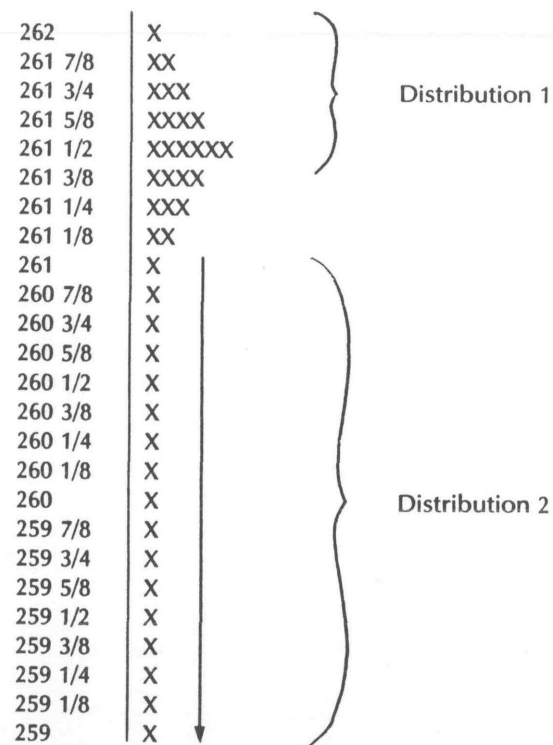


Figure 3-1. Minimum trend time/price chart. Distribution 2 begins when the market moves lower, seeking a fair price, having rejected the price area found in Distribution 1. In this example the second distribution is initiating — seeking a fair price to distribute around thus becoming responsive.

always trading well when the pit was full of people. This was because when the pit was full, the market was apt to continue moving in the same direction. When the pit emptied out, it was a period of low activity, meaning that the market would change direction. Often, I would still have my position on, and when the pit filled up again, the market usually would go in the opposite direction.

This happened to me enough times during my first two months in Chicago that I began to get out of my position

whenever I saw the market stop and the pit empty out. Then when the pit filled up again, I would go with the new market direction.

Later, when I formalized my understanding of the markets, I realized that this was related to the phenomenon of trade facilitation. When the market stops trading activity, it's near the end of the distribution on a day basis. I didn't associate this beyond a day for quite some time, but it's very relevant to reading the market, as you'll see later.

During this period, I gradually learned not to accept things as they were presented. One of the great fallacies propagated on the floor was that the commercials and the locals could cause the market to move. It took me about three months to realize that even when the locals and the commercials bought very heavily, they couldn't move the market very much because they were just making trades for the day—they weren't holding on. And these trades would be offset by other commercials and by traders' resting Orders.

So I wouldn't watch the locals and commercials for clues to price direction. The real directional strength in the market came from the people buying the off options—those for the more distant months—which represented about 10 to 15 percent of the market's volume. When these people started buying, they bought and didn't sell, so they would tighten up the pit by absorbing the available supply. The market would be moved up and down by a few days of people buying off options, not by those trading options of the nearby months.

So I had separated the market into two parts: the day traders, who were trading in the nearby months, and the investment traders, who, because of the six-month capital gains tax laws, invested six months or more out. I observed several months later that the local spreaders would be

moving back and forth between the off options and nearby options to even up the order flow from one area to the other. If the order flow from one area was all buy, the spreaders had to come over and cover the shortage, because they would not be able to get any sell Orders in that Option. With this observation I realized that the market was controlled not by the commercials, but by the small percentage of traders who held their positions for a long time. This was an important insight into the directional moves of the market.

Watching the spreaders operate in the market also told me that the people who were buying the distant options never bought or sold at the same time; so spreaders would have to carry inventories. In other words, they had to wait until the market moved high enough to shut off the buying and bring in selling in order to take off the spread. If they were scalp spreaders, they would try to take off all that they could. They also had to inventory, usually with losses, because there would only be either buying or selling due to the nature of the perceived opportunity for long-term investors at this price.

At about the same time, I realized that a premium price level on the nearby contracts compared to the deferred was always a bearish Situation in grain markets. This was because the market assessed it as a short-term shortage which would be corrected eventually. When the distant months were at a premium compared to the nearby, it indicated a long-term shortage. Consequently, this would attract investment buying, creating a carrying charge Situation.

This understanding was opposite to the perceived wisdom. We'd always get carrying charge markets when the market was good, which means that the speculator was carrying the inventory. And this was an indication to me

that the price of the most distant month—twelve months out—would set the overall price level for the commodity. If soybeans were trading for \$2.50 and the new crop Situation looked good, there was a chance that beans might go to \$3.00. But if beans were \$2.75 or \$2.80 and it looked like a new crop was going to be priced at \$2.25, there was no way that beans were going to enjoy a sustained rally.

EXPOSURE, EXCESSES AND THE LONG- AND SHORT-TERM TRADER

With these realizations, I started to chart the minimum trends of both the nearby options and the most distant options. If the most distant options were very strong, I would be buying into the weakness of the front month. I did very well on this strategy because I knew that no matter how many big locals were selling, they couldn't break it out the other side. The locals would get in during the day, and the commercial activity would be balanced between the buyers and the sellers. The commercials wouldn't take a big speculative position; they were just hedging their near-term commitments and looking for a fair price during the day. I was able to determine a fair price by the groupings of minimum trends. When I got a price that was trying to make a new low when deferred options were too strong to make new lows, I really was buying price below value.

The biggest compliment I got for my trading ability came from two distinguished old gentlemen who traded the off Option beans, when there wasn't much physical activity in the pit (so they wouldn't get pushed or shoved around). At first, these two men told me they would take the op-

posite side any time I wanted to trade. If I wanted to buy 10 or 25 beans, they'd seil to me at the seller's price; they'd make any trade I wanted. But after about four months of trading with me, these two gentlemen closed the account. They said I was too good to trade against.

There were a lot of successful traders on the floor who had name recognition and followings of their own. Whenever one of them traded, a lot of other people would come in behind him and do the same thing. The good traders took advantage of this. They knew that there was going to be a lot of buying or selling behind them. The good trader would assess that buying or selling activity to see whether it pushed the market further. If it didn't, he'd be the first to get out.

This "free peek" at the market was very important and a good advantage for the prominent traders. I realized that one key to trading success was exposure in the marketplace; and, for the first time, I saw that market activity could be described by volume. The important thing to note was the amount of distribution this caused.

I also noticed that on the days when the market changed, I usually lost money. When the market moved in one direction with a lot of volume, äs a local trader, I'd seil against it and get hurt. Those one and two days a month, I was playing for the same norm that occurred on the other 18 trading days, and it was very difficult for me to make money. Since each bad day subtracted from my winning days, I figured that if I could recognize this type of day and refrain from trading, I'd be money ahead. But what was most frustrating was that these losing days were the really active days in the market.

In trying to classify trading days, I first discovered that we had two types of days—those that were active early and traded out during the day, and very big days that devel-

oped all day long and just went in one direction. The off-option traders were the key to determining which type of day it would be. If they were very active early, there would be a big price range that we would tend to stay within. If we had no apparent big activity early but small, continued activity during the day, then the market would continue in the same direction without much setback.

Another observation I made—perhaps the most important—had to do with the speed of price change. The faster the market moved, the more it indicated that the current price was an excess or a non-competitive area of the market. As a local trader, you learned to perceive this in varying degrees. The principle behind it was that this excessive price area—too high or too low—would act as a barrier against further price movement in that direction. This is one of the best reference points a trader can have.

Fortunately or unfortunately, these excesses occur in varying sample sizes. But they are always there, and they can occur at any time during a trading session. It's extremely important to pick them up to avoid a no-win situation—namely, having a position on with no chance that the market will go your way.

THE COMMON LAWS OF THE MARKETPLACE

Through my early trading experiences and observations, I began to see that all markets were basically the same. The commodity markets were no different from my father selling grain for a fair price or our ranch hands buying used cars or guns when the prices were attractive. In all markets there are two distinct areas and two distinct types of participants—the day trader and the beyond-the-day trader.

Price is the lever that regulates these two areas of the market. In the day area, the purpose of the market is to find a fair price so that trade can take place. (No one will intentionally trade at an unfair price.) In the beyond-the-day area, price regulates the activity of the long-term buyer or seller by moving up and down.

For example, if there is a lot of building activity in a local real estate market, prices for labor and materials, interest rates and other expenses will tend to hold or increase. If in the following year the building activity is cut in half, prices will probably fall. The combination of short-term and long-term activity creates an opportunity for those who discern it. For instance, you can have an unfair low price in the day time frame coinciding with a high degree of buying activity; or you can have an unfair high price coinciding with low or neutral long-term market activity. Observations like these give us a set of circumstances that we can deal with logically as traders.

From following my experiences and observations during my early years in Chicago, you are probably beginning to see—as I did—that it is possible to read the market in the present tense, not just after the fact. If you can do this, there are definite advantages for you as a trader.

Changing Markets

After about five years of trading at the Chicago Board of Trade, I began to see the need for some changes in my trading methods. What do you do when the indicators you are accustomed to leaning on no longer work? Experience is the best form of knowledge; but occasionally you come to a point at which you have to chuck experience and gain new insights. This is especially true in a dynamic, changing marketplace. In such a market, change equals opportunity.

A small example illustrates this point. One day, early in my trading years, I was an active corn buyer at the opening. A very nice old gentleman with about 30 years' trading experience tapped me on the shoulder and said, "Son, do you see those rail car loadings in Chicago? That means the commercial people are going to be sellers. I advise you to get out of the market."

I thanked the old gentleman for his opinion—he was trying to help a young trader out—but I disregarded his advice. I knew that the rail car theory was outdated and no longer reflected the market.

THE ADVENT OF COMMODITY TRADING FUNDS

The first major change I had to adjust to occurred in the late sixties. For the first time, we had trading by com-

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modity mutual funds that would buy huge quantities at higher than high prices. Prices would go up, and instead of selling, the funds would buy. This was the beginning of the historic change in the ratio of responsive to initiating activity.

For the first time, I realized that enough money could drive the market far enough against me in a low-margin Situation so that I'd have to cover it. This was hard for me to deal with because I had always feit that no one could hurt me unless I was wrong. That was no longer the case. Now my principal was much more at risk than ever before.

During the 1968-69 period, more and more commodity trading funds came into being. The floor trader's strategy was to let them push the price way out of line and then try to guess when they would end their activity. The idea was not to make the first trade, but to try to make the last trade. However, the volume of trading generated by the funds created a problem for the floor traders, in that there was usually a large distribution with accompanying volume. This meant that the market would continue, taking away any advantage from making the last trade as well.

There was one exception to this — when the funds drove the price high enough to give us an excess, that is, a quick fall away from the peak price. These excesses in price coincided with a new-found volatility in the market. My confidence level declined at this time because I really didn't know how to handle this activity. I was smart enough not to take any chances by selling into ridiculous prices because things were changing, so I had to reassess my position and my approach to the market.

My earlier approach had worked for some time, but it no longer seemed viable because the potential profits were small in relation to the moves that were taking place. I realized this, and my volume of trading declined — not be-

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cause of losses, but because I cut back my trading so as to figure out a new approach. I needed to fix the broken gate rather than ignore it.

I've always set a great deal of store by being in control of myself and, whenever possible, of the market. The importance of this had been brought home to me once back when I was first starting in Chicago. I was long 25 soy beans, and the market was up 6 cents. This meant \$1,500 profit for the day — a tremendous amount of money for me at the time — but I knew the position was worth a lot more than that. So I decided to ride it out, even though the market might set me back.

At first, it did set back, to the point where my \$1,500 profit had declined to \$800 profit. But it moved sharply my way several days later, and I ended up making a larger profit on the trade. I won because I was in control of the market and my emotions at all times; my decisions had been based not on money, but on opportunity.

Now, several years later, the market had changed. It seemed that I could no longer control the Situation, as I had with the 25 beans back in 1965. So I was trying to buy rallies and sell breaks a little more often. This was extremely difficult to do because I had been conditioned against it. I could understand the need for the market to change in order to attract new participants and grow, but I wasn't adapting to the change; I was avoiding the Situation. It took me about six months to regain control. Once I did, I could buy rallies or sell breaks without being nervous. I was back in step with the markets.

This reinforces the meaning of my basic equation:

$$\text{Market Understanding} \times \text{You} = \text{Results}$$

The seventies proved to be an exciting decade for commodities due to the tremendous upheavals in most sectors

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of our economy. But it would have been a traumatic period for me had I not been able to make the earlier adjustment. Many people who were successful during the seventies lost their money in the eighties because the markets changed again, but they didn't. So one of the keys to being a successful trader over a period of time is to adapt to change. You must be able to find a new program when one is needed and have the discipline to implement it.

THE 1970s: GREATER MARKETS, GREATER OPPORTUNITIES

All this time, I was using the same minimum trend charting format, but the markets were getting broader and broader, and there was a lot more opportunity. I got to the point where I couldn't keep my minimum trend notations on the piece of paper I was carrying, so I began doing it mentally. I would visualize where the range of 70 to 75 percent of the trading volume was taking place, and then I would mentally plot the prices above and below this area.

My strategy was mainly a follow-through strategy. If the market moved above the first Standard deviation, I would go with it initially and see whether volume attached itself to it. If the market didn't attach volume to it, I would start working out the position. But it was very rare that I got in front of the market in a responsive way as I had in the sixties, so trading was fairly easy. I didn't have to keep track of a lot of things; I was mainly following the first Standard deviation of volume, then going with the market out of that. The markets were so dynamic in those days

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that even a small move was more than enough of a range from which to operate.

Another change that occurred in the 1970s was a change in the speed of decisions required by the trader. Generally speaking, a responsive trade is a trade for tomorrow, and you have almost all day to make the trade, given a fair price/value relationship. However, initiating trades call for an immediate response, and the tendency is for the trade to get away from you before you can act. It's important to note that the ending of one activity is the beginning of a new one; a good trader must perceive this.

It's important to sense the undercurrent of change and the direction in which it's moving so that you can catch its development. As I've been describing, the markets changed slowly in 1969 and 1970, and faster in 1973. I looked for a change in the late seventies, and it occurred; as this is written (late 1988), I am looking for another change. In fact, I'm constantly looking for the real change that may be masked by the old activity. Being prepared for change is part of the program of the successful trader.

THE DISTANT MONTHS DECLINE IN IMPORTANCE

The last big change took place in 1981. It affected the type of Information I had been using in my trading decisions. Changes in the tax laws eliminated the six-month holding period for all commodity income. Consequently, all the activity that I had been tracking on the distant months was no longer there; it was only a nominal market.

Every marketplace must give you a price/value relationship. Before this change, I had used the most distant months

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to establish my price/value relationship. If I felt that the Overall price level of the distant months was too low or too high, that gave me some bearing in the market. (I still use the distant months in this way, but it's much more difficult because the volume of activity is usually so low. However, when there is economic reason and heavy activity in the distant months, as during 1987 and 1988, I am able to get a very solid reading.)

So in 1981 I had to find a new way to determine what the beyond-the-day time frame trader was doing. He was obviously still trading; he just had to be trading more of the nearby-month contracts. The market was showing more of a day trade influence; it had become more of a spot month market. The futures markets became still more volatile because the spot month wasn't cushioned by activity in the distant months. All the activity would rush in, and it would be all buying or all selling. I found that we were having 15- and 20-cent ranges even on what we considered light activity. This made it difficult to read the market.

Prior to 1981, the spreaders were probably the most successful group trading as a unit at the Board of Trade. The long-term traders could afford to pay a premium to get in and get out, and the spreaders capitalized on that premium. The spreaders would sell to them when they wanted to buy and buy from them when they wanted to sell, using the front month as the pivot to anchor the trades.

The spreaders were very, very successful. So with the onslaught of the new 1981 tax law and the lack of trading in the back months, the spreaders really had no more business. Previously, by observing their activity, I could sense what the beyond-the-day traders were doing. Now I had to find another way of picking up this information.

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A NEW KEY: THE FIRST HOUR OF TRADING

I made a decision, based on experience, that a day time frame trader would usually trade during the first hour of trading; or, at least, that enough day traders would trade during this period to give a good indication of what a fair first hour's price would be. Then I knew that the other time frame traders would all act in concert—either all buying or all selling—so the movement of price beyond the first hour could be attributed to their activity.

I had observed for several months that the buy brokers or sell brokers would be consistently active in small but consistent quantities as the market was developing. So if the market exceeded the first hour's range, I would attribute this change in the fair price to an adjustment to the beyond-the-day traders' activity. The magnitude of this adjustment would tell me the degree of their activity and how much further the market had to adjust in order to find a new fair price.

When the market is very active in the early part of the day, you know what to expect. But if you don't have a lot of activity, there are several possibilities as to what the day will be like. By analyzing the first hour of trading, I was able to break down everyday market activity into four types of days: non-trend days, trend days (the big days I usually lost money on), normal days (with big opening activity) and normal Variation days (which extended the range because of buying and selling). I found that about 99 percent of all days fit into one of these categories.

If I was able to figure out what type of day it was going to be, then the trading was easier because I could implement a trading program geared to that type of day. I ran into difficulty if I tried, for example, to trade a normal day like a trend day. The idea is that in the present tense you

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should be able to determine which type of day you are dealing with. (Later in this book, I'll develop these concepts more fully.)

Actually, my deciding to categorize the days by looking at the first hour of trading was an arbitrary choice. I was trying to isolate the day time frame traders, and the first hour of the day is a time when the market settles out. By then, everybody who wants to trade has done so or has expressed an interest in trading. And I was concerned only with how the people who didn't have to trade—like the ranch employees who didn't have to buy a used car or gun—would operate.

Once I had that reading, I would operate in the pit by either buying breaks or selling rallies within the developing 70 percent of activity. When we got to the low of the 70 percent of activity and we had nothing but buying by the broker groups, then I would be a buyer down towards the end, and hold even as it moved toward the top. If there was no activity, I could buy because it wasn't going anywhere anyway, but I would sell as it moved toward the top because there was no concerted buying activity that the market needed to adjust for.

To move directionally, the market needs concerted activity, and I learned to judge how much there was. I could keep track of all markets because I monitored the range for the first hour of trading to see whether it extended itself in one direction or the other. Then I would compare the volume in the market that day with the volume of the previous day. If it was higher, the market would be at least unchanged if it didn't continue; if it was lower, I would look for an unchanged or changed direction.

The important thing to note here is that I'm in position for two of the three things that can happen in the market: the market can continue, change or stay the same. By

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putting "stay the same" on your side of the ledger, you add a profitable time allocation and increase your chance of keeping or making money past the 50 percent mark. This is a much better strategy than the usual win-or-lose approach.

NON-TREND DAYS AND NEW ACTIVITY

There weren't many slow markets in the seventies, but whenever they did occur, I wondered how I could possibly make a living in this business. I traded hard, but there was no possibility to make money; no Orders were coming in, and there was no range. There was no way I could force the market to make money for me.

The day after one of these down sessions, I would get in there and take a position. I would buy, say, 50 beans, and the market would move up. I'd take a cent profit and have a \$500 return—and I was glad to get it. At this point in time, I was like my father worshipping cash, because I saw lean times ahead. I took the sure thing every time. But nine times out of ten, it would turn out to be a real big day, where that 50 lot would be worth \$10,000 instead of \$500. After a slow day, you don't see a lot of opportunity in the market, so you're naturally cautious and conservative. Yet this is the wrong time to play it safe.

It's analogous to my early experiences with the pit emptying out, which I did not at first recognize as an opportunity. Principles remain the same but must be applied to new situations. It took me 15 years to figure this out, instead of the two months it should have taken. But at least new discoveries continue to come my way—as they will for you.

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What I call non-trend days don't occur very much any more, but they were fairly common in the seventies and early eighties. One day, the market wouldn't do anything, and the next day would be a big one. These days generally marked the end of one trend and the beginning of a new one. Although we rarely get non-trend days any more, except during holidays, they still have the same significance: the market tries to make itself hard to read because you're trying to associate volume with an activity. When you can't figure out what the market is trying to do, it's very hard to apply the volume to an unknown market activity.

Another thing that helped me develop as a trader was watching young traders who didn't know what they were doing but who still made money consistently by adapting to the environment. Such a trader's style would appear to be one that I wouldn't even consider adapting; on the surface, it didn't appear possible that this style could work. Yet it did. So my challenge was to look beneath the style to the underlying principle. This kind of learning exercise has not only helped me find some good new ideas about trading, but also helped me to stay mentally young in my approach to the markets.

I found that observing market activity brought the day into focus and allowed me to put two or three days together and work with larger sample sizes. Basically, I was just ballparking all of this information. I was really following volume, so whenever an up day had more volume than the previous day, or felt that way, I was sure that the market was going to be unchanged or higher. The key point is that most days are related to the previous days. The market gives you a price/value relationship that is slow to change. Most traders are trading for the unrelated days,

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which occur less than 10 percent of the time, while 90 percent of days are related to the preceding day.

People would do a lot better in their day trading, swing trading or long-term trading if they would realize that the market takes time to change. The idea that most days are related to the previous day is a good illustration of that.

DYNAMISM OF THE MARKETS

One consistent trend since the 1960s is that markets are becoming more and more volatile. With the trend toward bigger daily ranges continuing, the markets are becoming even more volatile because they're moving more to the nearby or spot month. As we move toward 24-hour trading, we're going to have still bigger ranges and more volatility due to increased spot month trading. The ranges in the cash markets already exceed the ranges in the futures markets on a daily basis. And as the influence of long-term traders is concentrating in the spot month, their numbers are also shrinking in the more distant months — thereby affecting the stability of market activity.

Times have changed, markets have changed. People who look back and say, "Oh, this is like the '61 market," or "It's the '78 market all over again," are going to have difficulty because the conditions surrounding the markets have changed. Markets never really repeat themselves. People who expend their energy on researching past markets are remiss because they're not taking themselves into the present through a good, solid analysis. My ability to adjust my trading strategy to the type of market I'm working with in the here and now has been a key to my success. Working

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with an evolving market allows one to make changes; studying past markets doesn't. Continual adjustment is at the heart of being a good trader.

We are all intertwined with markets in our everyday lives, although we may not always realize it or understand the nature of the markets themselves. Until recently, markets have been a mystery to most people; they were set up to be used by experts, and only experts could understand the data the markets produced. In the information age we are now entering, more and more people are learning to deal with the key pieces of information that markets focus on. But it takes time, background, memory—and mistakes—to develop the ability to do this.

Traders who study my market principles sometimes run into difficulties because they expect too much, too soon. Learning to understand the markets is a long process; there are no simple answers to many of the questions markets raise. What you need is a flexible but disciplined approach to the principles of the market that will allow you to gain the information you need to reach your trading goals.

5

The Information Revolution

In the early 1980s, the Chicago Board of Trade sparked an information revolution by making available information that had never before been disseminated by the marketplace. The effect of this revolution was to demystify the markets by allowing people on the outside to more easily determine what everyday traders were doing.

OPENING UP THE MARKET

When I was elected a director of the Board of Trade in 1981, I was given responsibility for market information. From my base at the statistical department, I felt that by bringing a lot more information out to the public we could change the closed image of the industry into a more open one.

At that time, Les Rosenthal, the chairman of the exchange, was a strong supporter of opening up the industry. In the early stages, our requests for information were pretty rudimentary. For example, at first we just wanted information on cleared trades from the clearinghouse. No one else had ever had this data. When our request came to Chairman Rosenthal's attention, he backed us. He understood that the Board of Trade would benefit from opening

iip. Without Mr. Rosenthal's strong support, the committee wouldn't have had the Information needed to formalize data from the markets nor the money required to carry out this important work.

The only real project criterion that Chairman Rosenthal gave me was this: Don't do anything that could harm the markets of the locals at the Board of Trade. I shared this concern. My friends' memberships were worth a lot. Would we come out with something that could ruin them, now or in the future? I didn't think that could happen, but I admit losing some sleep over the possibility.

The anxiety about what our work might mean spread through the industry. Rumors were everywhere. One story had it that local traders would no longer be needed, and that they were already being eliminated in Bermuda and at other exchanges. Chicago would be next, some said.

Of course, as it turned out, the information revolution didn't harm the markets or the local traders; rather, it benefited them greatly. But at the time, what we were trying to do was so new that many people didn't understand it.

PRICE RECURRENCE AND VOLUME

The information revolution of the early eighties provided price data organized in a way that did not bend the structure of the market to fit the discipline. Instead, prices were arranged to show price recurrence, which would help to define market use. Prior to this time, price information had been disseminated, but never in a form that clearly reflected price differences. People learning to trade were treating all prices the same, when, in fact, prices in any marketplace are perceived as different by different people with different programs and different desires. At the Board

of Trade, we wanted our new organization of data to reflect these differences. The form this new organization took—designed to highlight patterns of price recurrence—was known as Market Profile.®

The second part of the revolution was the dissemination of volume data at each price traded. The most important factor in any marketplace is volume. Volume defines market activity, and volume never lies. It shows what is truly happening, and not just what is happening on the surface. So we knew that it was important to show volume information in as timely and accurate a fashion as possible.

We worked out a System whereby, although we received our CBOT volume data a bit late, it wasn't a bulk line release; when 200,000 contracts were traded, we knew the volume at each time/price occurrence. How fortunate we were in comparison to the buyers who tried to find out how many sheep my father had bought or sold, and at what price. He would never reveal this data to anyone who wasn't a party to the transaction. Now this kind of vital information was made available by a major exchange, to the benefit of the entire trading community. The name of this new System was the Liquidity Data Bank (LDB).®

Additionally, we broke down the volume data into two categories. The first was the local trader who traded for his own account; the second was the commercial trader who traded for the house account. The CBOT felt that if people became aware of how these Professional traders

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operated, they would gain a better understanding of the fact that Professionals use the market in a logical way. Ever since the inception of commodity markets, there have been accusations in the press of price manipulation on the exchanges. Since CBOT trading data has been openly revealed, no such allegations have been supported by the record of actual trading in the marketplace. The best defense of futures markets has been to open the books for all to see.

Local activity is one of the most reliable volume indicators at the CBOT. It varies between 53 and 57 percent of total volume on any given day, with the first Standard deviation falling somewhere between 55 and 56 percent. This has been very consistent, illustrating the consistent liquidity provided by local traders.

By defining commercial activity and then applying volume to it, we developed a good understanding of the commercials' role in the marketplace. Commercial volume had never been revealed before, and everyone anticipated that the commercials would balk at the prospect of revealing it; their propensity for secrecy was well known. But we found that the commercials actually enjoyed having their volume as a group available publicly because it allowed them to see what the other commercials were doing. There haven't been any complaints about our data releases, and no one has been harmed by them. In fact, everyone has benefitted because now the public speculator has more information to assemble into a package.

Almost everyone questioned our idea of having volume after the close. "How can that do you any good?" they asked. In fact, it does a lot of good once you realize how important volume is for trade facilitation. You can appreciate the value of volume information if you've ever tried to trade in what we call a nominal market, where there is

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no transaction data to work with. The lack of such data tends to enhance the mystery of the marketplace and drive people away from trading.

People are familiar with transactional data in everyday markets—the housing market, the auto market, the grocery store—and it is important for them to assimilate the same type of data with regard to the futures markets. Once they understand that, in the most basic ways, all markets are the same, and that data flow in all markets, they will be able to assimilate data to use in the commodity markets just as they already do in everyday markets.

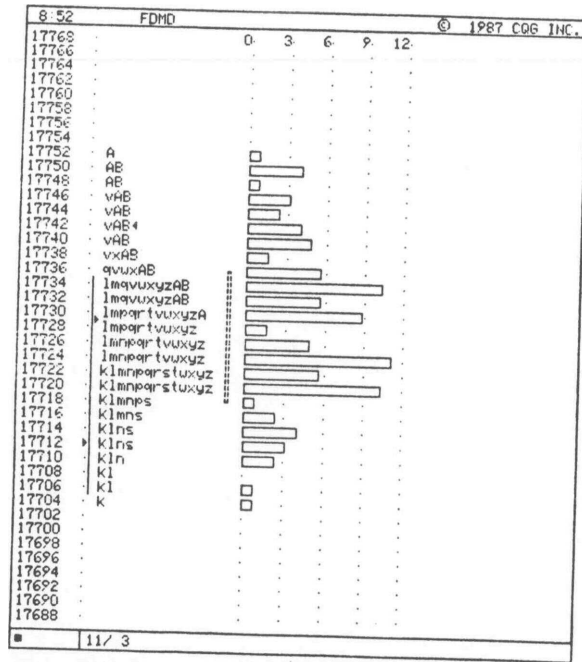
THE NATURAL ORGANIZATION OF THE MARKET - REVEALED

As we ran our initial market information programs at the CBOT in 1981, we saw that all the commodities we plugged into them revealed a beautiful sense of cosmic order, just as it said in my 1958 statistics textbook. The classic shape of the bell curve appeared on our screen, just as I'd surmised it would (see Figure 5-1). The first Standard deviation—using 70 percent of volume on a normal day—was right in the price/time relationship. (Price + Time = Value)

With our data and our program, we had accomplished two things: we had captured the market's natural organization, and we had assembled volume information with which we could describe this activity. The public speculator could now relate to the basic market equation:

[Price - Time = Value]

People could now associate a certain price over a period of time with value. When the market is overvalued or undervalued, they could look for the conditions that would



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Figure 5-1. Profile of the 24-hour cash market in Deutsche Marks, illustrating an almost perfect profile. Note how the high-volume concentration in the center of the profile corresponds to the price/time value area, and how the market feathers out equally on the two extremes. (Cash quotes courtesy of Midland Bank.)

cause the market to move up or down. These changing conditions, in turn, dictate whether people will buy or sell.

It was difficult trying to fulfill a new role in the marketplace—that of providing on-time information. The CBOT deserves a lot of credit for its leadership in initiating the project. Between 1981 and 1984, we worked long and hard on it and spent a lot of money. Now that work is coming to fruition for the good of the entire industry. I think a lesson has emerged that all exchanges must heed:

The exchanges are information centers. The more information they disseminate, the more people will trade and the more successful the exchanges will be.

FUNDAMENTAL, MECHANICAL AND NATURAL INFORMATION

Since we have been discussing the importance of information in the marketplace, let's take a moment to consider the various sources of information available to a trader and how they should be used.

There are three main types of information that you need to apply in the marketplace: the fundamental, the mechanical or technical and the natural.

Fundamental information allows you to build your background and to place price in perspective. These are probably the two most important disciplines for a trader to develop. They allow you to take advantage of situations and enable you to sense opportunities. They make it possible for you to trade with confidence as you learn to "feel" the market.

Fundamental information is constantly available: from the news, trade Journals, government offices and trade reports. However, it is hard to acquire and use fundamental information in a timely fashion early in your trading career because you can't relate it to anything meaningful yet. You must build a bank of experience to which you can relate the fundamental information, and this takes time.

The difficulty in using fundamental information is that you must interpret the data; then this interpretation must be overlaid on the market itself. This calls for timing.

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Sometimes you have the "right" data, only to discover that the market is doing something else.

So most fundamental information, derived from outside the marketplace, should be used only as background. It can serve as a direct guide for trading only when price is very advantageous in relation to the data, or when the market is acting in accordance with the data. The difficulty of getting information on time and then applying it correctly has made fundamental information very hard to work with. As a result, most people do not use it.

Technical information, on the other hand, comes in a nice, neat package. It appears to be so easy to use that people flock to it. Technical data can be easy to see and easy to apply—but good results aren't so easy to achieve. Again, the problem is that some technical data are good and some are bad; the trader must make choices, interpret and then time the trade. Most traders make the mistake of using technical data as the basis for the decision-making process, when in fact, they should be used mainly for timing an idea.

Technical data are usually based on the forward projection of past data. But making accurate forward projections is a most difficult task in any profession. Those who have mastered some technical skills can use them fairly well. But since most forms of technical analysis don't distinguish among trades of difficult calibers, at times they lend themselves to large losing positions, as stops are filled far away from the intended areas.

Market Profile and Liquidity Data Bank are, in effect, technical information; but they are drawn from a different data base from other forms of technical information. Here the data base is evolving on-line, and the data represent the current Situation rather than the past. Market Profile provides faster information than other forms of technical

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analysis because it is closer to the currently developing data base, that is, the market. The LDB volume figures are past data, but they project continuation or change rather than higher or lower prices.

Given either a past or an on-line data base, the central question is the correctness of the definitions and parameters. This determines the accuracy and value of the information drawn from any data base: bad parameters yield bad information, while good parameters yield good information. The definitions and parameters I developed for Market Profile and LDB came from my experiences in trading the market, and they have proven to be useful. However, markets are dynamic. As they change, it is necessary to Update the technical parameters you use or find new ones, as we are now discovering with the advent of 24-hour trading.

After working with the markets for 25 years, I began to formulate my market theory. In the course of this work, I made a new discovery that I believe provides a new form of market information—the natural form. The natural flow of information allows you to get even closer to the market and to really experience it as it unfolds. Unlike fundamental and technical information, which are subject to individual interpretation and timing, the natural flow is objective: it is either present or not. You can choose to ignore it or place it into a different time frame, but the natural flow is still there and does not lend itself to misinterpretation. In this sense, I consider it the fastest, purest form of information.

This has opened up what I think is the best way of approaching the market—the natural way. This approach does not exclude any type of market information that may be available, but, in fact, allows you to understand them all a little better. It serves as the best base from which to in-

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corporate data and develop yourself as a trader. The remaining chapters of this book will deal in much more detail with the natural flow of information and how to use it in your trading.

THE SIGNIFICANCE OF MARKET PROFILE AND LDB

Everything that I had learned about the markets through my experiences prior to 1981 was formalized in the CBOT Market Profile and LDB. Through these two media, I was able to organize the market, define market activity and describe that activity by means of volume. Market Profile and LDB gave us practical, working formats for our technical information—information derived through definitions and parameters from a data base, which in this case was the evolving market.

Instead of trying to read the past and extrapolate to the future, as previous technical Systems had tried to do, the object of Market Profile and LDB was to understand the present as would a local on the floor. These tools have helped many traders learn to read the market as it develops so that their trading skills may grow on the basis of real experience.

PART II

MARKET PROFILE AND LIQUIDITY DATA BANK

Understanding Market Profile

Market Profile and Liquidity Data Bank crystallize the basic trading concepts I acquired after 25 years on the floor. These included my understanding of how the market worked, along with various trading assumptions and disciplines that had proven effective and stood the test of time.

During the 1980s, markets became much more volatile than they had previously been, with larger price ranges. Under these circumstances, as you'll see, the typical Market Profile evolved into a conglomerate of distributions rather than a single distribution. The use of Market Profile must evolve to fit these changing circumstances.

As a trader, along with my knowledge and experience, I always had an intuitive "feel" for the market—an understanding that I could never quite express, yet could use in any developing marketplace. This intuitive insight involves sensing opportunities and catching their development as it happens. In the trading classes I teach, which are always conducted live as the day's markets are developing, I've always been able to make adjustments or see exceptions to the parameters and disciplines I set out for the students. This isn't so much confusing to the class as amazing; and so I never tried to conceptualize these adjustments or exceptions in any coherent framework.

I reflected on this for quite some time and found myself beginning to explore my natural, intuitive feelings about trading. This led to the developments in the latter half of this book, which I believe are far superior in methodology to the mechanical approach of Market Profile. I don't mean that Market Profile and LDB aren't valuable; in fact, I still use all the data developed for them continually. But I've learned to incorporate these data into my natural way of trading.

Market Profile and LDB are quite simple in concept, but very complex in detail. By contrast, the natural way of trading is very simple in detail, yet complex in theory. I think it will be more profitable for you to concentrate on the complexities of the theory than on any mass of details. So in the chapters that follow, I make a deliberate effort not to overload you with details. I don't want to overwhelm you with despair at the size of the hill you are about to climb.

In this section of the book, I will explain what Market Profile is and the concepts behind it. I will present a few of the basic definitions and parameters based on it. Later, in the portion of this book dealing with trade preparation, I will use these concepts to guide you through techniques you can use in preparing for the day's trading. The focus will be on the natural way of trading and on how you can gradually incorporate the additional information that comes from Market Profile and LDB into your trading practices.

BASIC PRINCIPLES OF MARKET PROFILE

Let's start by laying out three operating principles that are behind Market Profile and LDB.

First, both Market Profile and LDB are a form of technical analysis, in that the information derived from them is mechanical in nature; it comes from strict and objective parameters and definitions. The difference between ordinary technical analysis and Market Profile is that Market Profile uses the evolving market as its data base rather than past market history. Second, Market Profile is more of a *present-tense* information source. It replicates what a trader standing in the pit can read because he too has pre-set parameters or concepts that allow him to read market activity as it develops.

A third difference between traditional technical analysis and Market Profile is that traditional technical analysis tried to predict the future based on the past, whereas Market Profile tries to identify the underlying conditions of the current market's movement for *continuation or change*. All of the parameters and definitions I prepared for Market Profile are sound because they are derived from experience and represent the principal, working parts of the market. However, markets are dynamic and changing, and as they change new parameters and definitions will be needed to represent the new areas of the market and the changes that have occurred.

The most noteworthy changes taking place currently are the emergence of the opportunity time frame within the 24-hour market and the fact that we are getting many more distributions during the day than we did previously. Adjusting our parameters to fit these new developments is not difficult; knowing that the adjustment is necessary is more difficult, especially for the new, developing trader. Fixing the gate isn't very hard; recognizing the need to do so is harder.

READING THE MARKET PROFILE CHART

In the Market Profile chart, prices are arranged along the vertical axis, with the highest price at the top and the lowest price at the bottom. Trading activity at each price is then graphically displayed on this chart. The trading day is divided into half-hour periods—a convenient, though arbitrary choice; some other time period could have been selected instead. These periods are labeled alphabetically, starting with a letter for the first trading period of the day, then progressing alphabetically. When a trade occurs at a particular price during a particular half-hour period, the letter for that period is displayed at the appropriate price point on the chart. As the day passes, and trades occur at various prices during different half-hour periods, a unique Market Profile for that day and that product is developed by using a bell curve.

The Market Profile presents a number of basic elements of the market in a rapidly-understood graphic form. The smallest possible unit is the time/price opportunity—a single letter representing a trade occurring at a given price at a given time. This is a direct descendent of John Schultz's minimum trend concept, the starting point for my thinking about markets.

Prices that occur often during the day, usually with the greatest volume of trade, are represented by a large horizontal bulge. Prices that occur less often are represented by the thinner parts of the profile. In most cases, the middle of the profile represents the area of fair price, where most of the trading occurs; the top and bottom represent relatively unfair prices, high and low respectively. By noting how widely dispersed the high and low excesses are and how far they are from the fair-price area, we can also

Understanding Market Profile

see the relative unfairness of the day's high and low prices, presenting some degree of imbalance.

In most cases, the Market Profile resembles a normal distribution curve, which, as statisticians have found, is the most common organizing principle in nature. Since market behavior is human behavior, it is logical to expect that prices would follow the same statistical patterns that govern other human groups.

Note, too, that the normal distribution form of the Market Profile also reflects the market phenomenon by which participation drops off as prices move higher or lower. Just as bidders in an auction market drop out, one by one as price increases, so the Market Profile curve tails off at the upper end of the price range; and, at the lower end, the curve tails off as sellers drop out of the market. This represents the declining volume of trade at these extreme price levels.

Another way of looking at the normal distribution presented in a Market Profile is through the concept of the Standard deviation, also drawn from the science of statistics. The Standard deviation is a way of measuring how far the values in any group of numbers vary from the mean, or average, value in the group. In any normal distribution, values within a given number of Standard deviations from the mean will occur with a predictable frequency. Normally, about two-thirds of the values will fall within one Standard deviation from the mean; 95 percent of the values will fall within two Standard deviations of the mean (see Figure 6-1).

Now that you understand what you are seeing when you look at a Market Profile, how can you use this information in analyzing market activity? Let's look at some details on how Market Profile reflects the development of a market as it happens.

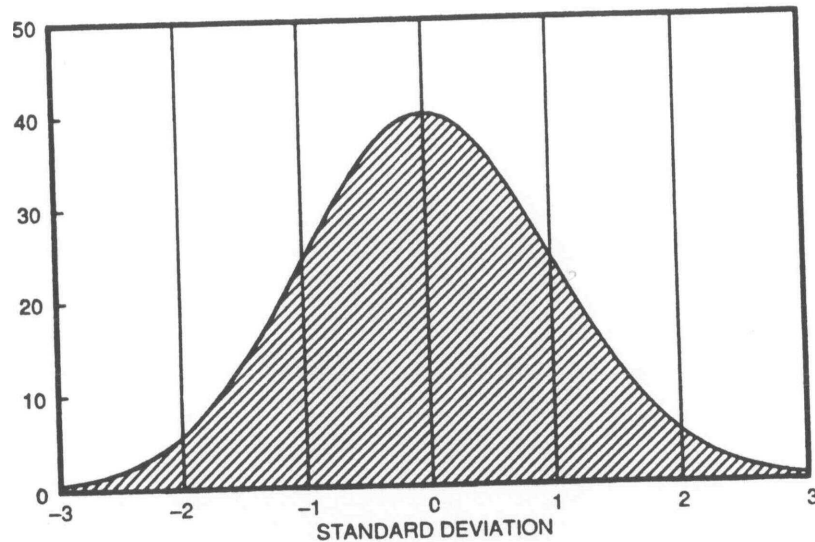


Figure 6-1. A normal distribution, with the first three Standard deviations in each direction indicated.

The skill of reading Market Profile can be broken into two parts. The first deals with the individual day, the second with beyond the day. It is the interaction of these two time frames that creates the conditions of opportunity. We need to examine them separately and then together to develop a good working understanding of Market Profile.

DAY STRUCTURES: FIVE TYPICAL PATTERNS

The purpose of the day structure is to find and maintain a fair price. This allows the market to do business because

no one intentionally trades at a price they know to be unfair. This activity of the market in seeking and maintaining a fair price needs to be explained in its relation to the day structure.

We begin our study of the day structure with the first hour's price range — the range represented by the first two half-hour Segments. This is defined as the first balance area of the day. Accumulated trades in this area represent a beginning fair price for day time frame traders, for they usually make up most of the volume during the first hour.

This is all well and good for them, but other traders soon come in to take advantage of that price. These are beyond-the-day traders. Their activity upsets the delicate balance, and, naturally, price has to move to make an adjustment. If they give the market only a little nudge, price will not move very far; if they give it a big push, price will move rather dramatically.

There is, then, a spectrum of possibilities, ranging from a small influence by long-term traders to a major influence. Let's consider some definitions that will help you understand how this spectrum works.

First, there is the non-trend day. On a non-trend day, long-term traders exert little or no influence on the market. The market exhibits no or almost no extension of its range of prices beyond what is seen in the first hour. Look at the Market Profile for October 31 in Figure 6-2; this is a good example of a non-trend day. The first hour's prices are represented by the *y* and *z* prints in the profile (because this market opened at 7:20 A.M.); note that the range for the day was extended by only one tick beyond the first hour's range (during the *D* period). This makes the day a non-trend day.

The next possibility is a day in which the market gets a slight push from the beyond-the-day traders, usually re-

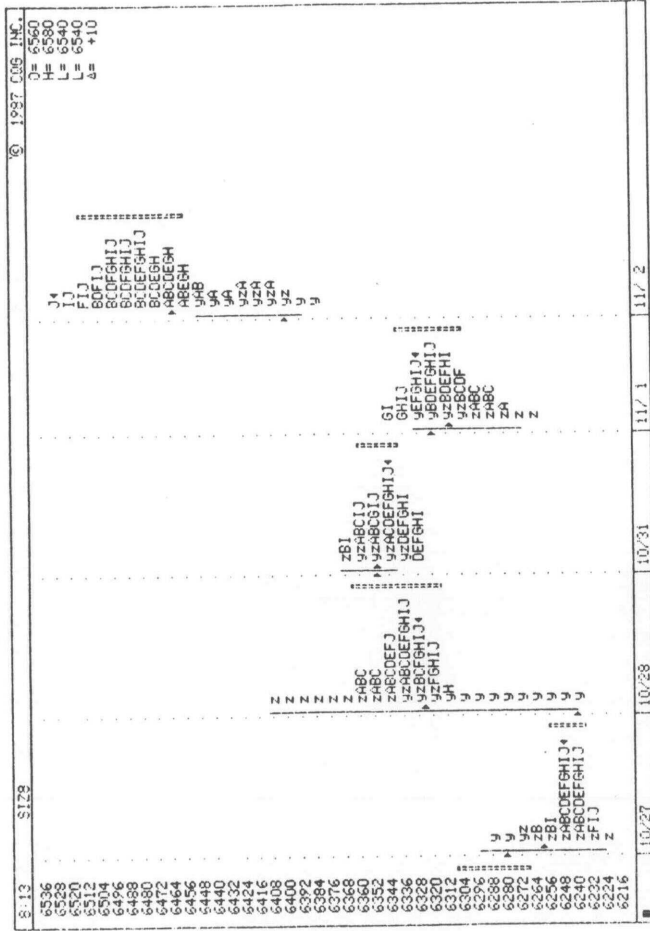


Figure 6-2. Five-day Market Profile for December 1988 silver. The profiles for October 28 and November 1 are examples of normal days; October 31 is a non-trend day; November 2 is a normal variation day.

sulting in a slight extension beyond the original range. We call this a normal day. On a normal day, outside or long-term activity represents about 10 to 20 percent of the trading activity for the day, and it produces a range extension of about 15 percent beyond the first hour's range.

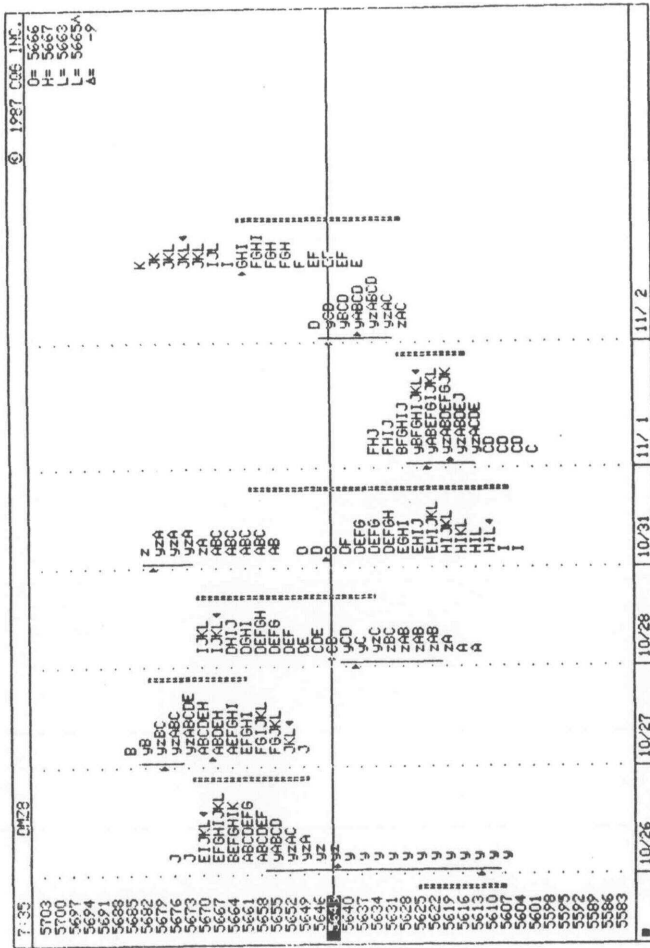
Figure 6-2 shows normal days: October 28 and November 1. Note that October 28 actually shows no range extension beyond the first hour's range. This is because the initial range was so large that it precluded any range development; instead, the day continued trading in the middle of the initial range. Thus, a normal day isn't invariably characterized by range extension.

Note that on either a normal day or a non-trend day, the first Standard deviation of volume will be in the middle of the range, with the second and third Standard deviations above and below.

The next type of day we call a normal Variation day. It takes place when the long time frame traders represent 20 to 40 percent of the activity for the day. As a rule, on a normal Variation day, the day's price range is about double the size of the first hour's range. In Figure 6-2, the profile for November 2 is a good example of a normal Variation day.

Next, we have a type of day known as a trend day. On a trend day, the outside traders represent about 40 to 60 percent on the market's activity. On a trend day, the market moves dramatically away from its opening price range. It normally closes within 5 percent of the extreme in the direction of its movement during the day.

In Figure 6-3, the profile for October 31 illustrates a trend day. The market opened at the top of its range for the day and closed near the bottom. Notice that the profile contains two patterns resembling the bell curve. These represent two distributions that occurred during the day,



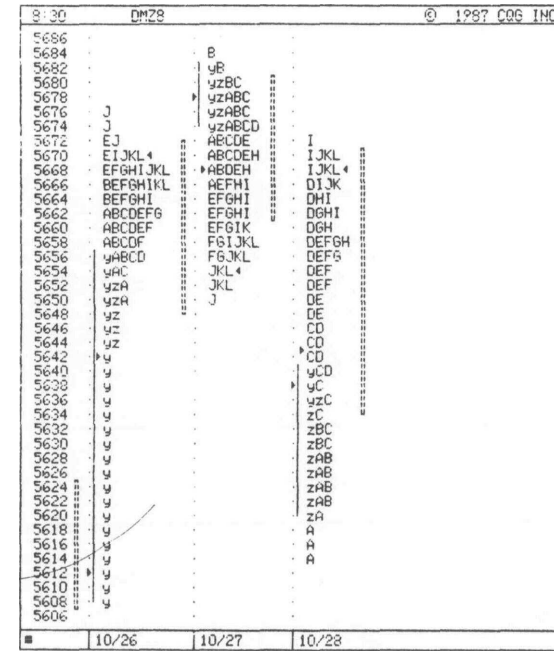
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Figure 6-3. Six-day profile for December 1988 Deutsche Marks. The profile for October 31 illustrates a trend day.

separated by a low-volume area near the middle of the range (highlighted by the line across the profile).

The fifth and final basic classification of days is the neutral day. This is a day in which the long-term traders exert two opposite and approximately equal influences. This causes both an upside and a downside range extension, netting out to no change for the day as a whole.

The new opportunity time frame created by the advent of 24-hour trading has had the greatest effect on the neutral day, as illustrated in Figure 6-4. This figure shows two neutral days. October 27 is an "old-style" neutral day, in



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Figure 6-4. A three-day Deutsche Mark profile, illustrating two neutral days: an old-style neutral day (October 27) and a new-style neutral day (October 28).

which the market closed near the middle of the range for the day, creating a basically balanced profile.

By contrast, October 28 is a "new-style" neutral day, influenced by the 24-hour trader. The day started in much the same way as the preceding day, but when the market failed to make a substantial new low in a period, opportunity time frame traders rushed in to buy. As a result, the market ended up, with an unbalanced profile. Thus, the rule of thumb stating that neutral days usually close near the middle of a range needs to be reconsidered in light of current changes in the marketplace.

Almost any trading day will fall into one of these classifications — non-trend day, normal day, normal Variation day, trend day or neutral day. Each involves a different set of likely range parameters, produced by a particular imbalance between short-term and long-term traders. If you can make the correct classification as the day develops, you will understand how far the market is likely to move.

BEYOND-THE-DAY ACTIVITY

We know that the beyond-the-day trader will be buying or selling at different price areas in the market; and we know, from experience, that long-term traders do not trade with one another but almost always with the day traders. So we need to be able to look at the range and development of our Market Profile and extract from it the long-term trader's activity. The long-term trader will be active throughout the profile, so we need to examine the profile in its entirety so as not to miss any information.

Let's start by defining some important terms that will help us understand the long-term activity. The first term

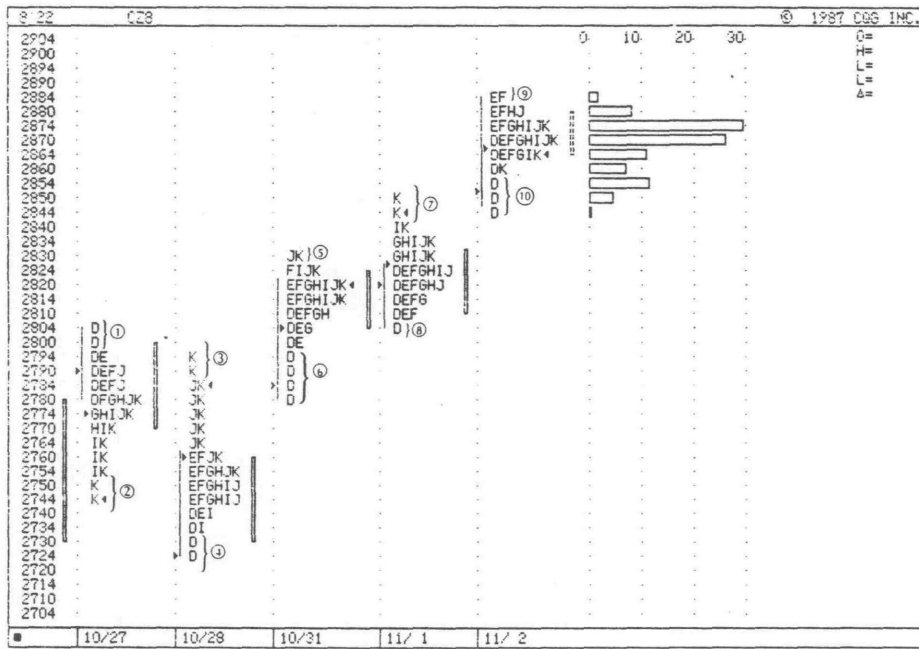
is an extreme. An extreme is activity at the top or bottom of the price range, represented by two or more time/price opportunities (prints on the profile) by themselves at the upper or lower end of the profile. An extreme cannot occur in the last time period for trading because there is no following trade against which to test it. By definition, an extreme is a price which the market has tested, then moved away from.

Figure 6-5 contains some examples of extremes, together with some patterns that might resemble extremes but which don't really fit our definition.

The elements labeled *1*, *4*, *6* and *10* in the figure are extremes. Each is a series of two or more time/price opportunities that the market moved away from as an unfair price. On the other hand, the portions of the figure labeled *2*, *3* and *7* are not extremes; since they occurred during the last time period for trading, these prices were not tested by any succeeding trade. The prints labeled *5* and *9* are not extremes either; each shows trade at the given price during more than one time period. Finally, the print labeled *8* is also not an extreme; only a single tick at the low end of the profile is involved. An extreme, by definition, must have two ticks or more.

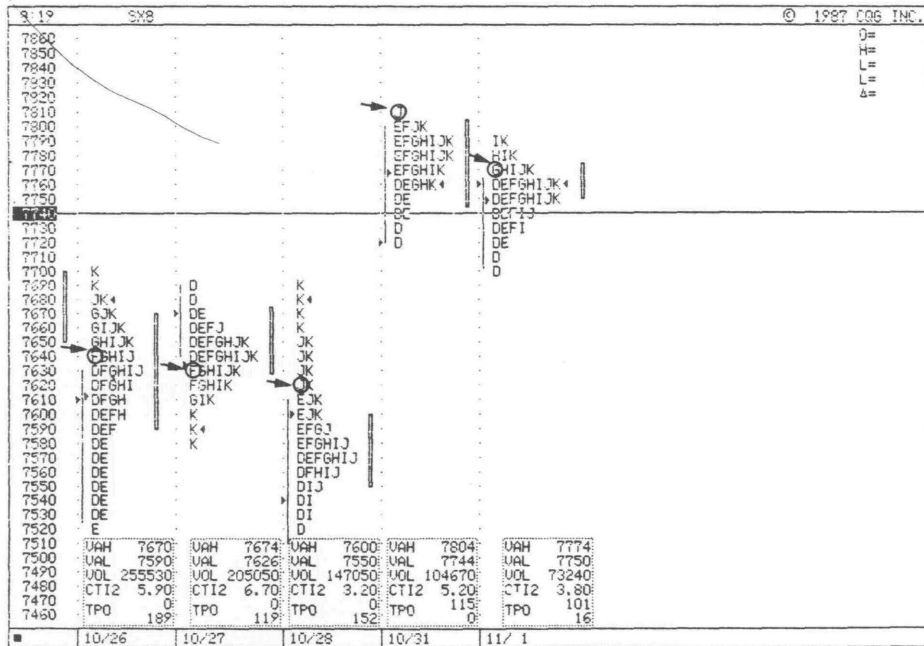
Another important term is range extension. This is, simply, any extension in the price range for the day that occurs beyond the first hour of trading. In Figure 6-6, the first hour's trading for each day is represented by the *D* and *E* print. The point at which range extension occurred each day is represented by the circled print. In each case, this was the first time/price opportunity for the day located beyond the first hour's range.

One more important term to understand is the TPO count. This is a useful indicator of market activity. To find the TPO count for any given day, first locate the price with



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Figure 6-5. Five-day profile of December 1988 corn. The portions numbered 1, 4, 6, and 10 are all extremes; the others are not.



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Figure 6-6. Five-day profile for November 1988 soybeans. The circled prints represent the points at which range extension occurred on each of the five days.

the greatest number of time/price opportunities (TPOs) nearest the middle of the range. Then count the number of TPOs above and below this line. The result is the TPO count.

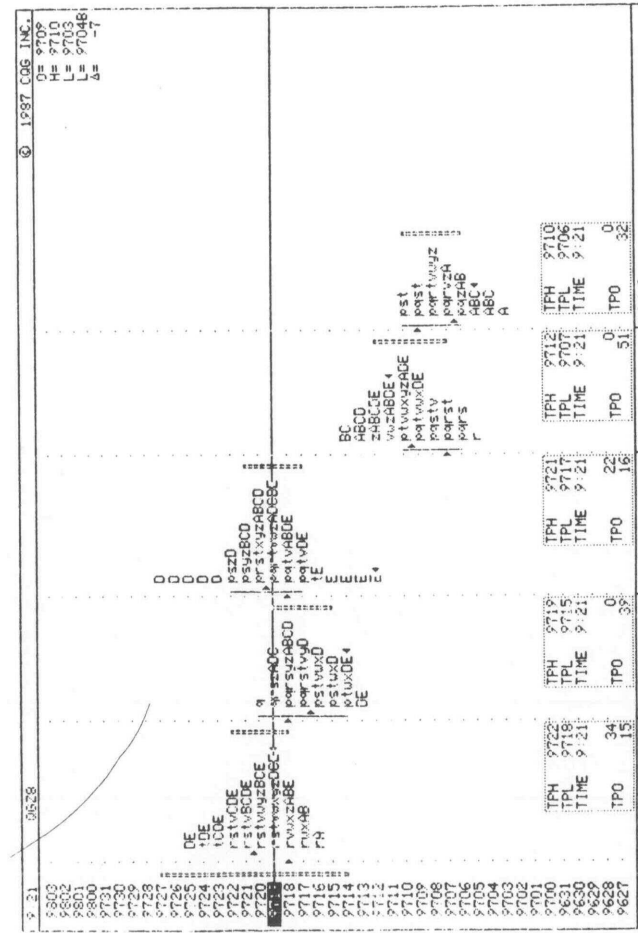
Figures 6-7 and 6-8 give two examples of the TPO count.

As you can see in Figure 6-7, on November 1 there was a greater number of TPOs above the center line than below it—22 to 16. (The TPO count is shown in the box at the bottom of the profile.) This means that the day was, on balance, a selling day in this area of the range.

In Figure 6-8, by contrast, we see that the ratio was almost reversed; on November 2, there were 19 TPOs above the center line, 22 below. This means the day was a buying day in this area of the range.

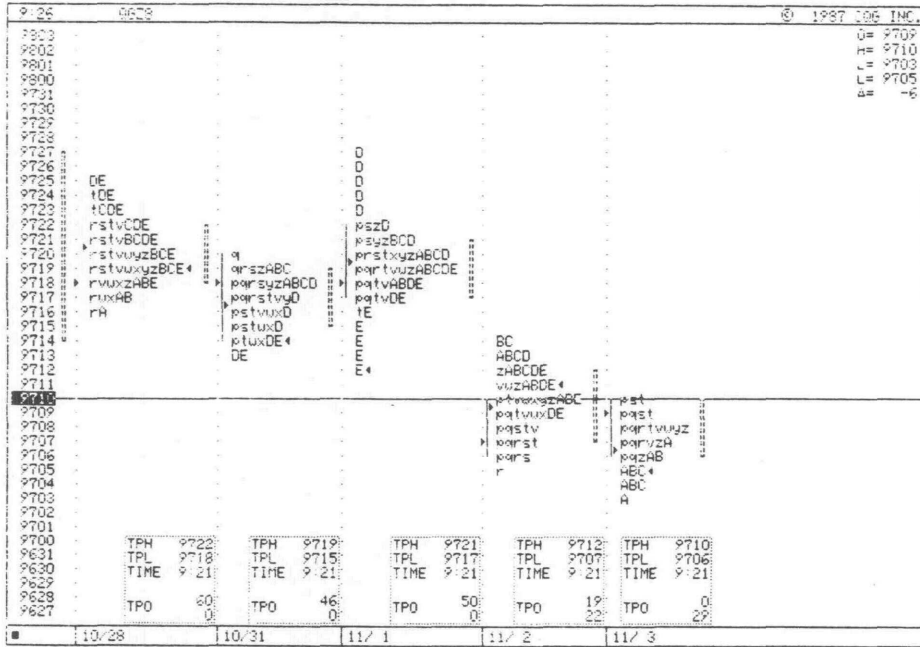
By monitoring extremes, range extension and the TPO count for any developing market, you can gain a sense of what long-term traders are doing. As long as the activity of the beyond-the-day traders is unbalanced, the price level will tend to maintain itself or move directionally. For instance, five consecutive days of activity with ten buys and three sells will mean that the market should hold its price, if not move higher. Conversely, if there were three buys and ten sells, we would expect to see prices either remain the same or fall.

As you can see, then, combining your understanding of the day and beyond-the-day disciplines, the lever that causes market activity to increase or decrease is the raising or lowering of prices. A large day time frame influence pushing prices down creates a good opportunity for the long-term trader to enter the market. By the same token, too large an imbalance of buying that ends a long-term market spree usually creates a good opportunity for the day trader since it will probably cause an excess in the marketplace once it moves away.



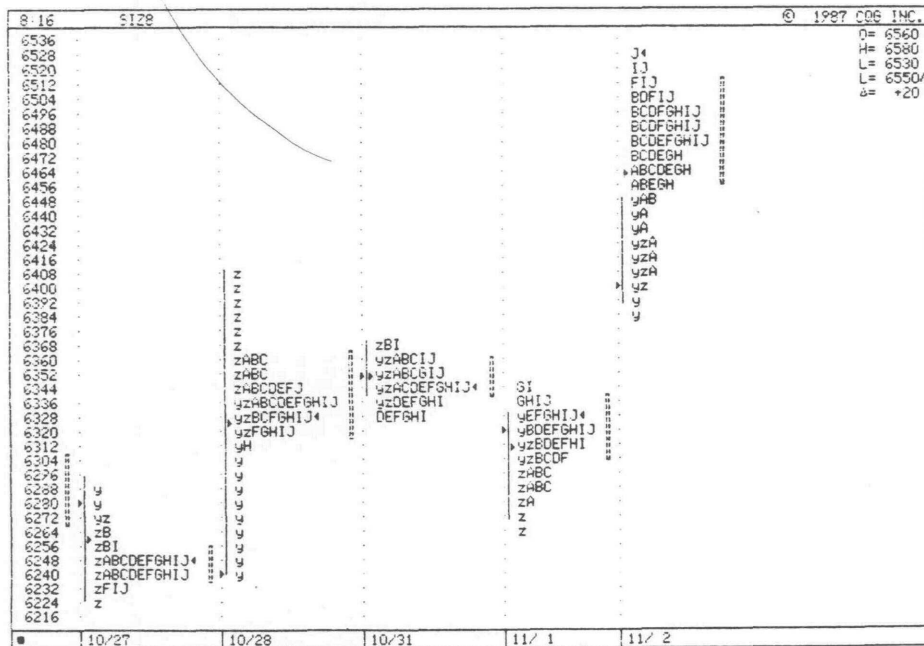
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Figure 6-7. Five-day profile of London gilt market. Count the TPOs above and below the center line for November 1 to gauge relative buying and selling activity.



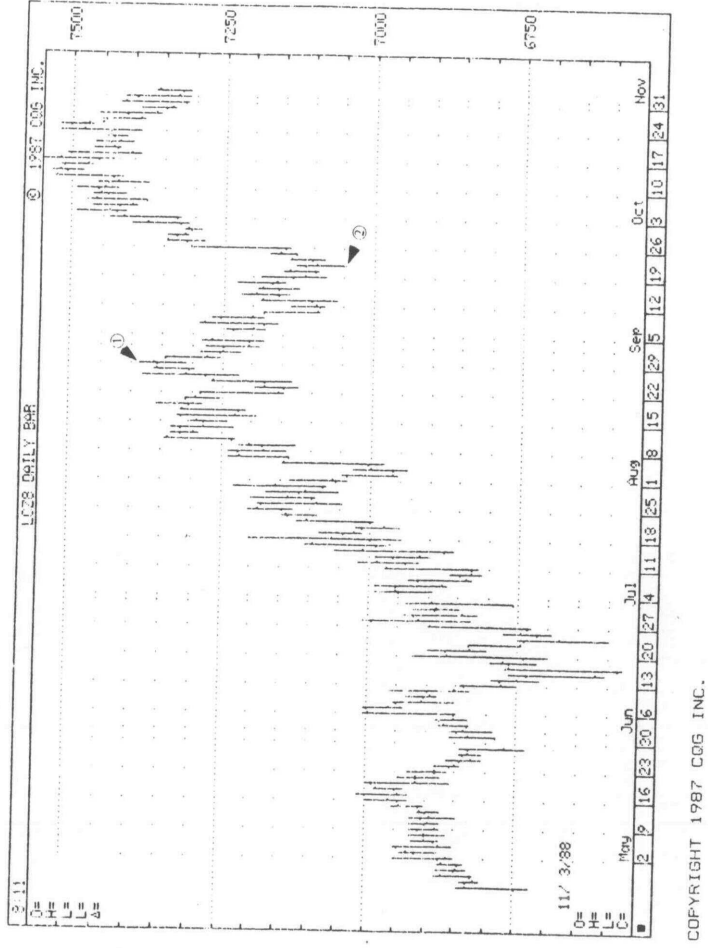
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Figure 6-8. Same set of profiles as Figure 6-7; but compare the TPO count for November 2 with that for November 1.



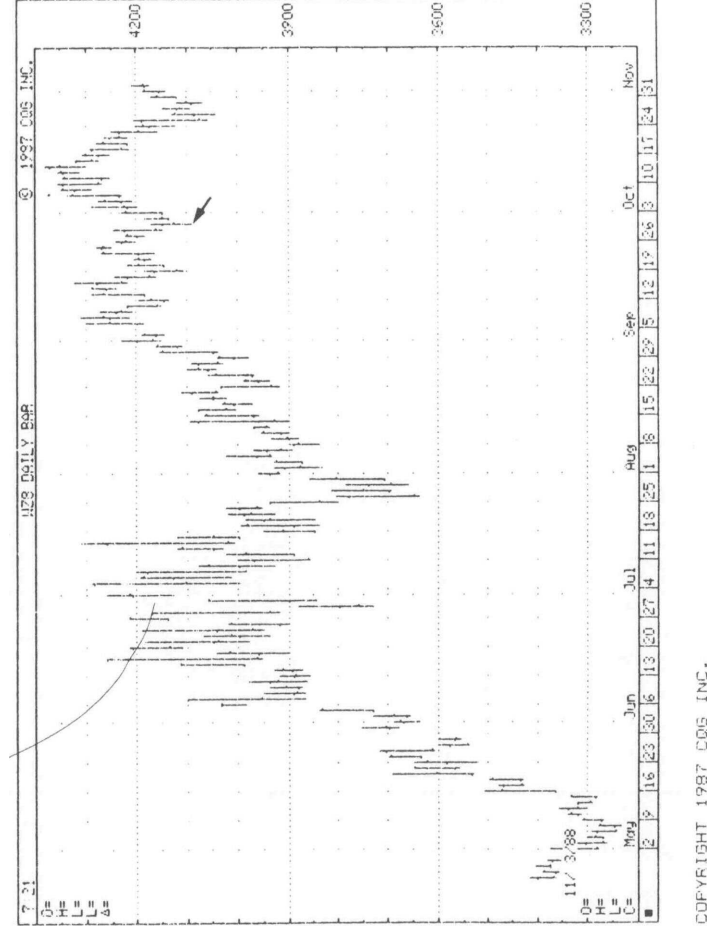
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Figure 6-9. Five-day profile for December 1988 silver. November 2 shows an example of a typical initiating day, with trading occurring above the previous day's value area. The market moves quickly, leaving the trader little time to buy at an advantageous price. By contrast, on the previous day (November 1), there was plenty of time available to make the responsive trade (below the previous day's value area).



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Figure 6-10. Daily bar chart for December 1988 live cattle futures. Points 1 and 2 represent price excesses.



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Figure 6-11. Daily bar chart for December 1988 wheat futures. The arrow indicates an excess.

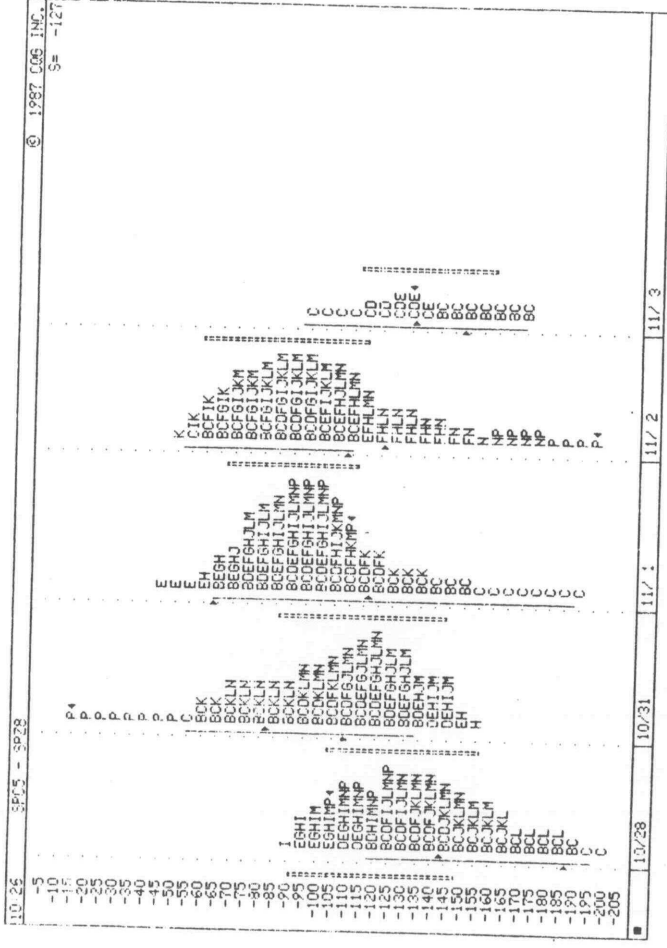


Figure 6-12. Five-day profile for the spread between the cash Standard & Poor's 500 and the Standard & Poor's 500 futures contract.

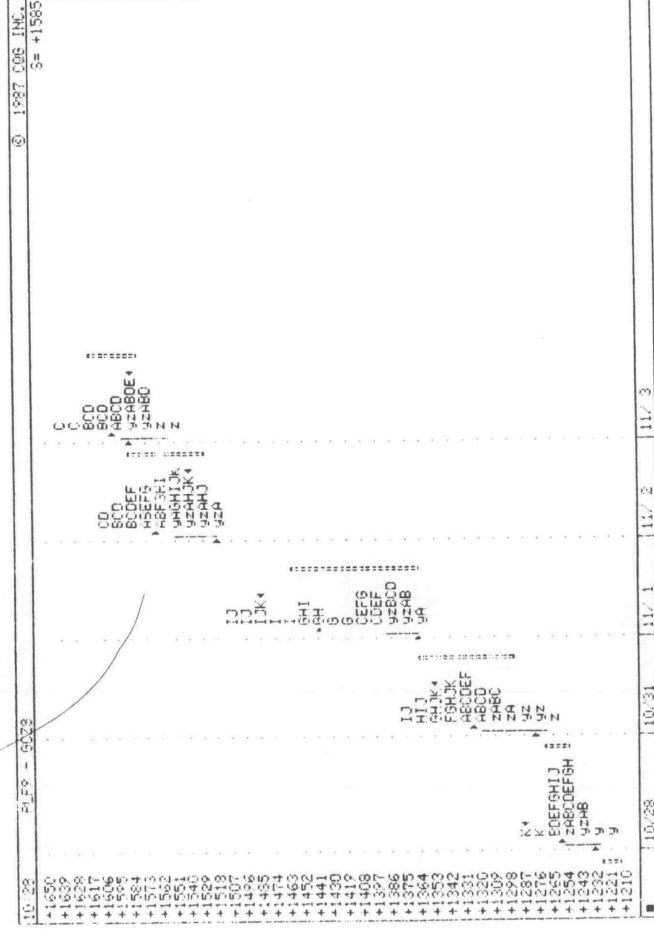


Figure 6-13. Five-day profile for the spread between platinum and gold.

Price cannot simultaneously serve two masters. This is the basic principle that creates opportunity for you as a trader.

INITIATING VS. RESPONSIVE ACTIVITY

Understanding and distinguishing between these two types of activity are difficult for many traders. In this section, we'll give some tips that should help you deal with them conceptually and practically.

First, let's consider initiating and responsive activity as they relate to the previous day. Use the previous day's value area as a reference point. This is defined as the first Standard deviation of volume, as calculated by the Chicago Board of Trade in its Liquidity Data Bank volume release.

Next, reference the market activity of extremes, range extensions and time/price opportunities (TPOs) as they evolve in the newly developing day. The key is to track market activity above or below value. When today's activity is buying below the previous day's value area, this is responsive activity. So is selling above the value area.

By contrast, buying above the previous day's value area is initiating activity; so is selling below the value area (see Figure 6-9). Market activity directly opposite the previous day's value area is not given a name in this definition.

The concepts of initiating and responsive activity can also be related to developments within the day. Simply refer to the first, second and third Standard deviations of volume for the developing day. The market is described as initiating when it is in the second or third Standard deviation of volume; it is responsive in the first. This is illustrated in a later chapter.

EXCESSES

Excesses can occur in many fashions; they are a useful tool in reading the market, both short-term and long-term. Good floor traders learn to recognize excesses instinctively; they are usually characterized by fast, unanswered price movements in the market. Excesses become areas that constitute barriers to further price movement, and therefore make excellent reference points for the trader.

Figure 6-10, which shows the daily bar chart for December 1988 live cattle futures, includes two excellent examples of excesses. As it happens, I was teaching trading classes that included analysis of live, on-line market activity during each of these excesses.

The first (point 1) took place at the end of May. The market opened about 20 points higher and immediately dove. It was clear that this represented an excess that would be a barrier to further trade on the high end for some time.

The second (point 2) occurred late in September. The market opened, broke sharply, then rallied within three or four minutes. This established an excess on the down side. In both cases, it was the rapidity of price movement that signaled the excess.

Figure 6-11 is another example of a classic bar chart excess. On the day indicated by the arrow, the market opened, went lower and then closed around the middle of the range. This established a barrier to be traded against for the immediate future.

MARKET PROFILE AND SPREADS

The same kind of Market Profile, with similar reference points, is available for the various spread relationships that

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exist between different commodities. (As you know, a spread is a combined long and short position on two closely related contracts. A trader can profit from a spread depending on a change in the difference between the two prices.) If you are an experienced trader who likes to use spreads in your trading strategy, you'll find that you can use Market Profile to find profit opportunities in spreads as well as in any individual commodity or other contract.

Figures 6-12 and 6-13 are Market Profiles for two different spread relationships. Figure 6-12 depicts five days of the spread between the cash S&P 500 and the S&P futures contract. There was relatively little movement during this period. Figure 6-13 illustrates a much more volatile spread, that between platinum and gold. Note that the profile for this spread on October 28 was a nearly perfect normal curve, while the other days were unbalanced in one direction or another. As you'll learn in a later chapter, these unbalanced profiles are examples of a special type of distribution which I call the Steidlmayer Distribution—an important new concept in trading, and one that is increasingly relevant in today's volatile and fast-moving markets.

Market Profiles can also be created and used for trading individual Stocks, commodity options—anything traded on an organized exchange. Since the profile reflects the underlying nature of markets, which does not fundamentally differ from one market to another, the same basic methods can be applied no matter what contract, commodity or product is being bought and sold.

7

Understanding Liquidity Data Bank

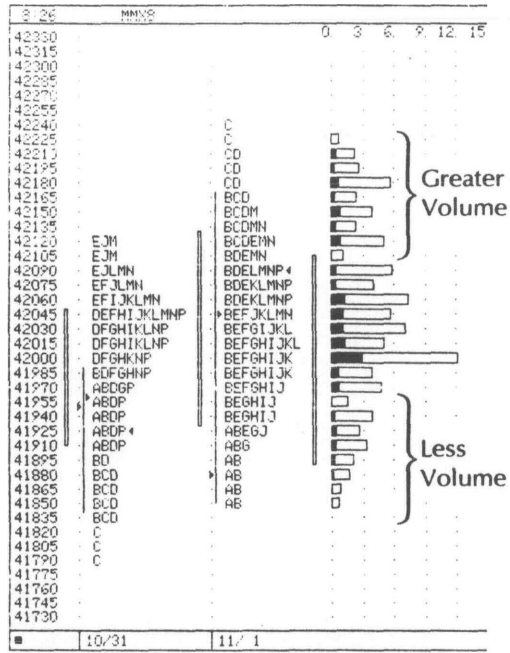
Liquidity Data Bank (LDB) is a volume report put out by the Chicago Board of Trade after the market closes. Its relevance lies in helping you determine whether a continuation or change in market activity is likely. The underlying assumption is that market behavior—mass human behavior—within the structure of the auction market is less likely to change on high volume than on low.

To illustrate this assumption, let's look at the volume profile shown in Figure 7-1. Notice the imbalance in volume between the upper and lower portions of the profile: There is relatively more volume at the higher price range than the lower. Since large volume activity does not—cannot—change very quickly, the lower prices occurring early in the next days profile represent a price opposite human behavior.

READING THE LDB REPORT

The best way to explain LDB is to examine the sample LDB printout shown in Figure 7-2 and explain its features, point by point.

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Figure 7-1. Market Profile and volume profile for November 1988 Major Market Index futures. Note the imbalance between the volume of trade at the upper and lower ends of the price range. The next day the market would stay the same or continue based on use of market by participants.

The first column of the printout shows a range of prices in ascending order. The second column shows the actual volume of trade at that price for the Session. (To be more precise, it actually reflects just about 75 percent of the volume for the day; this is because the data are derived from the second run from the CBOT clearinghouse, due to time constraints. However, this is a very accurate sample of the entire day's trading.)

Understanding Liquidity Data Bank

LIQUIDITY DATA BANK* REPORT
VOLUME/FUTURES SUMMARY REPORT FOR 11 1 88

CHICAGO BOARD OF TRADE
Commodity - U S BONDS DAY DEC 88
Volume Summary

| Price | Volume | %Vol | %Ctil | %Cti2 | %Cti3 | %Cti4 | Brackets |
|---------------------------------|--------|--------|--------|-------|-------|-------|--------------|
| 9116 | 9312 | 1.8 | 23.6 | 39.4 | 6.1 | 30.9 | D |
| 9115 | 5334 | 1.0 | 40.6 | 9.0 | 1.1 | 49.2 | D |
| 9114 | 12264 | 2.3 | 58.5 | 15.9 | 1.5 | 24.1 | CD |
| 9113 | 21432 | 4.1 | 57.9 | 14.3 | 4.7 | 23.1 | CD |
| 9112 | 14750 | 2.8 | 56.6 | 16.4 | 3.8 | 23.3 | CD |
| 9111 | 14816 | 2.8 | 56.9 | 13.8 | 4.3 | 25.0 | CD |
| 9110 | 13370 | 2.6 | 58.1 | 19.2 | 6.2 | 16.5 | CDE |
| 9109 | 8718 | 1.7 | 57.8 | 17.4 | 3.5 | 21.4 | ABCDE |
| 9108 | 30276 | 5.8 | 60.1 | 8.7 | 6.3 | 24.8 | ABCE |
| 9107 | 54778 | 10.5 | 59.1 | 16.6 | 3.3 | 20.9 | ABCE |
| 9106 | 46756 | 8.9 | 61.8 | 13.0 | 4.5 | 20.7 | ABCE |
| 9105 | 21822 | 4.2 | 58.7 | 14.1 | 8.7 | 18.5 | ABCEFGHKL |
| 9104 | 48788 | 9.3 | 61.0 | 16.9 | 3.5 | 18.7 | BCEFGHKL |
| 9103 | 62218 | 11.9 | 60.7 | 13.4 | 4.8 | 21.1 | EFGHIKLM |
| 9102 | 57926 | 11.1 | 61.9 | 14.8 | 4.2 | 19.2 | EFGIJKLM |
| 9101 | 34714 | 6.6 | 61.1 | 11.4 | 3.4 | 24.2 | EFGIJKL |
| 9100 | 35344 | 6.8 | 60.4 | 14.8 | 4.3 | 20.5 | EFGIJK |
| 9031 | 16480 | 3.2 | 64.9 | 11.3 | 5.2 | 18.5 | EGIJK |
| 9030 | 12562 | 2.4 | 59.9 | 14.3 | 6.2 | 19.7 | IJK |
| 9029 | 1292 | 0.2 | 49.8 | 16.8 | 1.7 | 31.7 | IJ |
| 70% | 9107 | 378826 | 60.9 | 14.4 | 4.4 | 20.4 | ABCEFGHIJKLM |
| V-A | 9031 | | | | | | |
| Volume for U S BONDS DAY DEC 88 | | | 522952 | 59.4 | 14.7 | 4.5 | %CTI3 |
| Volume for all U S BONDS DAY | | | 549490 | 59.0 | 14.8 | 4.5 | %CTI4 |
| | | | | | | | 21.5 |
| | | | | | | | 21.7 |

* CHICAGO BOARD OF TRADE, Volume/Futures Summary Report for November 1, 1988

The third column shows the percentage of trade occurring at each price as related to the entire day. The fourth column contains what we call CTI codes, which reflect the commodity trader Identification breakdown. These codes have the following meanings:

CTI-1: Local traders.

CTI-2: Commercial traders trading for their own house accounts.

CTI-3: Members trading off the floor, or having other members fill and order for them.

CTI-4: The general public.

The CTI-2 category designates the commercial trader who is Clearing trades at the CBOT or who is a member of the exchange. It is possible for a person in this category to move a trade into CTI-4 if he wants to hide it. CTI-4 also includes many commercial firms that are not members of the exchange and are mainly making hedging trades. These trades, which don't show up in LDB as commercial trades, really belong in that category. Nevertheless, the CTI-2 category has proven to be a reliable indicator of commercial activity.

The last column is the volume profile that visually summarizes all of this data.

The bottom horizontal line of the report in the left-hand corner shows a calculation of the first Standard deviation of volume, provided by the CBOT. This represents the volume value area for the day. As you proceed toward the right, the various percentages in this area of the printout reflect, first, the overall volume value area (70 percent plus breakage) and then the percentage for each of the four trading groups. The last line of the report gives the total volume for the day for the contract in all contract months.

Figure 7-3 shows the volume profile for the same day in the market seen in Figure 7-2, together with the following day for comparison purposes.

STEPS IN INTERPRETING THE LDB REPORT

As we've said, the primary purpose of the LDB report is to help you determine the likelihood of *continuation* or *change* in the market. Here are the steps to follow in making this determination.

1. Try to determine in what direction the market was trying to go during the Session. Was it trying to go higher, lower, a mixture of both—or is it impossible to tell? Don't be embarrassed to put a question mark here—sometimes it's difficult to determine.
2. Having made this determination to the best of your ability, check whether volume was higher or lower than the previous day. More volume, coupled with a clear direction for the market, means continuation; lower volume means change.
3. Next, look at the extremes of the column showing volume percentages. Depending on the size of the day's range, count off three or four ticks from the top and three or four ticks from the bottom. Find the total percentage of trade in these two areas. The comparison between the two numbers may be significant. For example, if we had 9 percent of the day's trade in the top four prices, and just 4 percent in the bottom four prices—and the market was higher on the day—this would indicate continuation on the up side. Conversely, if we

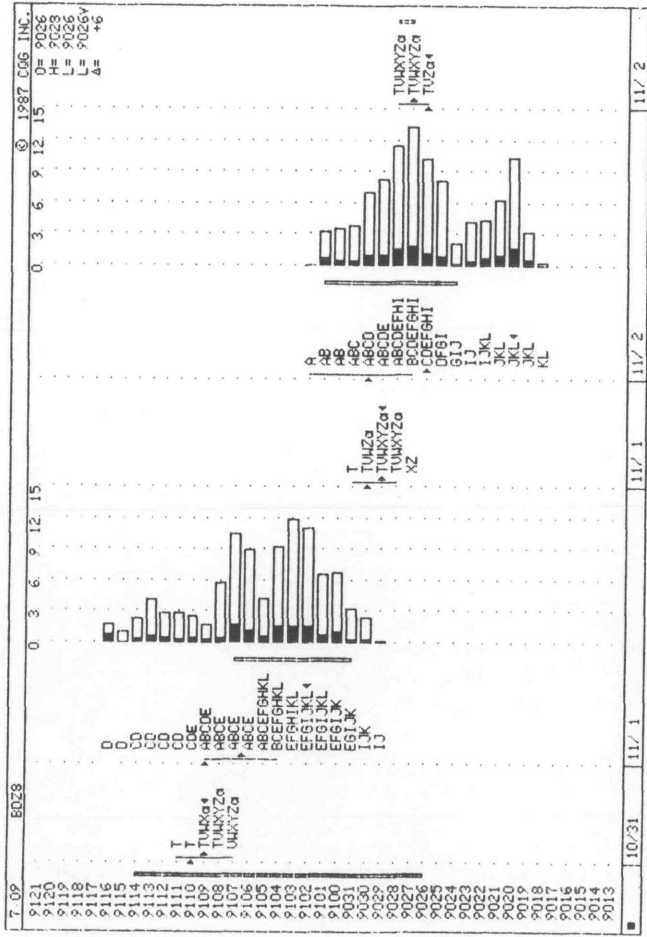


Figure 7-3. Volume Profile for December 1988 T-Bonds, including both November 1 and November 2.

had 4 percent on the top and 9 percent on the bottom—and an up market—this would be a contraindication for continuation on the up side.

4. Compare the range of the volume value area for the day to that of the previous day. Is it larger or smaller? If it is larger and the market is up, it is a positive sign for continuation; if it is smaller, it is a negative sign for continuation.

5. Compare the volume value area to the TPO value area, which is the part of the price range containing two or more time/price opportunities. Note the spatial relationship of the two, with the volume value area having greater significance. For instance, if the volume value area is toward the bottom of the TPO value area, and the market is higher, that is a negative for continuation. Conversely, if the volume value area is toward the top of the TPO value area—or even extends a tick or two beyond it—that would be a plus for continuation. This procedure is something like finding the "specific gravity" of the market; it suggests the direction in which the market appears to be weighted.

6. Find the volume in the top half of the range and compare it to the volume in the bottom half of the range. Compare this ratio to the trend for the day—higher or lower—and the result will be either positive or negative for continuation.

The Wxt step in analyzing the LDB report is to move on to the commercial activity section. Again, we'll operate on certain basic assumptions. The commercial trader does two types of trading: he trades for the day and for beyond the day. And the commercial trader is the closest thing to a purely responsive trader.

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For example, the commercial trader may be in some business which requires him to consume a certain amount of grain every day. As a result, he must do some business for today. At the same time, he is doing forward business; for instance, he may have made a deal with some foreign buyer for six months down the line. Both the day need and the beyond-the-day need must be covered in the marketplace.

Our assumption or definition is that the commercial everyday trades usually take place within the volume value area, while his new, long-term business falls outside it. This is because, in general, his customers are people who are shopping for good prices. He may buy one million bushels of corn in the value area to cover his daily needs; but if the market breaks three or four cents a bushel, the customer may decide that this is a good price and buy it from the commercial trader, who, in turn, must buy the corresponding amount of grain in the market. So the commercial activity is mostly responsive.

This doesn't mean that the commercial never makes initiating trades; he does. It would be unusual activity, which should be noted when it does occur.

It is important to note, then, the amount of commercial volume that takes place within the volume value area. Did the commercial trader do more business here today than yesterday? There is a Standard figure in every market. In bonds, for example, the Standard is about 13 percent in this area, meaning that the commercials, on average, do about 13 percent of the bond trading that falls in the volume value area. Compare this with today's figure; if today's figure is higher than the Standard, it is a positive sign for continuation.

Then, determine the commercial outside activity—is it normal or abnormal? To decide, make the following cal-

Understanding Liquidity Data Bank

ulation. Take the range of prices above and below the volume value area. Add the total percentages of commercial trading at these prices and divide by the number of prices. This gives you an average percentage, which is either higher or lower than the percentage of activity within the volume value area. If lower, disregard it. If higher, assume that the commercials were trading responsively. If you note a large amount of buying activity in your profile, assume that the commercials were buying.

These, then, are the basic disciplines for analyzing LDB. Using them, you'll find that, about 70 percent of the time you can determine accurately whether the market will be higher, lower or unchanged the next day. This can help you to be patient, or conversely, can reinforce the need to make an immediate trade promptly, depending on other factors.

In trying to determine whether to anticipate higher, lower or unchanged values, don't just add up the pluses and minuses. Instead, learn to select and focus on the most important factor. This will vary from time to time. Generally, the most important thing to determine is the trade facilitation direction. The second most important is whether volume is higher or lower; the third most important is the range [of the volume value area; and the fourth most important is the spatial relationship between the volume value area and the TPO area.

Finally, if commercial activity is abnormal—either buying high or selling low—this may be the most important factor in the market. However, if you find the commercial aspect of the analysis confusing, drop it for now. It can be quite helpful, but you may need to work your way into it gradually.

Let's refer back to the T-Bonds example (Figure 7-4) and go through the exercise in detail. This will familiarize

cent. On prices above 9107, commercial volume ran at an average of 17 percent. The conclusion would be that commercials sold early in the day, stopping the first attempt to rally. They then probably bought on the break, since the market bounced late. Thus, commercial activity is normal. Overall, we would look for unchanged to lower activity based on higher volume and the normal nature of the commercials' trading.

The key in this analysis is not to be absolute in your conclusions but rather to try to get a feel for what is going on. In this case, indicators 2, 5, 6, and the commercial analysis tell us to look for continuation, while indicator 3 is non-committal and indicator 4 looks for change. Consequently, we would expect the market to be lower or unchanged in range on the following day. This would be our expectation in our first approach to the market, until we noted some change or detected some error in our analysis.

This is *not* an especially clear cut example. Most markets are like this. When a market is unusually clear, you'll notice the difference.

THE MIDDAY RELEASE OF LDB

The midday release of volume figures by CBOT is, of course, closer to the live market than the previous day's figures, and you can use it to look for significant changes in volume as compared to the mass of human behavior from the previous day's close. The midday release represents an estimated 25 percent of the day's total volume. It appears too late and is too slow to help you determine which volume for the day will be higher or lower; most of the Session is over by the time the release is available, which is too late.

Its main value lies in its ability to help you determine the direction the market is trying to move in if the day is to be a two-part day—that is, one with two distributions.

Suppose that during the first part of the day the market was trying to go higher, and 75,000 contracts were traded. During the balance of the day, the market was trying to move down, and 200,000 contracts were traded. This breakdown would enable you to define market activity with volume, much like the leading traders back in the 1960s, who knew that other traders would follow their lead, whether they were buying or selling.

The midday release can also give you low-volume numbers—prices at which a small amount of trading is occurring. These often serve as support and resistance areas for the remainder of the trading Session.

Furthermore, the midday release can help you gain some insight into early and late trade facilitation, and it can help you take a position for the next day. One stable element of the market that can help with this is the level of commercial activity as compared to the previous day. If it differs from the norm by several points, this can be significant and can help you make trading decisions.

ASSESSING THE SIGNIFICANCE OF COMMERCIAL ACTIVITY

As an example of commercial activity, let me cite an example from a trading class I taught in May 1988. At the time, the price of soybeans was around \$7.50. The prospect of a drought had increased the price substantially, and since the whole growing season was ahead of us, I felt that beans were overvalued.

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However, looking at commercial volume releases for the previous ten days, I found that commercial activity on the rally days had been less than 5 percent—very low. As responsive traders and long-term opportunity seekers, the commercials should have been heavy sellers, especially at the high end of the price range.

This told me that we had one of two possible situations. First, the commercials might have already taken advantage of lower prices by hedging, and were in a predicament and could not sell more; or, second, they might simply have no desire to sell at all. Consequently, I reconsidered my idea that the market was overvalued and decided that the market must be at value after all.

Maybe you know how the story ended. Subsequent activity found the market trading between \$7.50 and \$10.50, as the crop became seriously hurt by the 1988 drought. So although I had been right to abandon the idea that the market was overvalued, my second assessment had still been wrong; at \$7.50, the market was undervalued, not at value.

A good trading friend of mine, Kenny Mitchell, pointed out to me in the midst of that year's summer volatility in the markets, that soybeans had been over \$9 fewer than 20 or 25 days in their entire history. Thus, the \$9 price had not stood the test of time in the marketplace. This leads one to believe that \$9 will remain an overvalued area, unless the market begins to spend more time there.

All of this suggests an idea on how good traders assess opportunities in the light of background information. You wouldn't want to make a stand at \$9.00 on the basis of beans briefly reaching \$10. Be aware of background information like this so that, when you do make mistakes, they will be minor ones from which you can recover. Don't trade absolutes.

v. 11

PART III READING THE MARKET NATURALLY

8**The Steidlmayer Theory of
Markets**

To be of value, a theory must be practical and capable of being used by people. Throughout this book, we've tried to combine practical guidelines for learning how to read and use the markets with the underlying principles of how markets work. In this chapter, we'll state in concise form the theory of markets that has grown out of my work; then we'll explain in some detail the meaning and practical implications of each word in the theory. By the end of this discussion, you should have all the basic information you need to understand markets and how they work.

Concisely stated, the Steidlmayer theory of markets is as follows:

The market is an organized medium that expresses human behaviors in different price areas at a given point in time, always presenting an opportunity to someone.

Though this Statement appears simple, it contains a lot of meaning. Let's look closely at each word in this statement so that you can fully understand the theory and its implications for you as a trader.

THE MARKET

The market is a location that constitutes a base for Services. It establishes rules and regulations for participants and products as well as a centralized meeting place in which market activity can take place. In the past, market locations have been fixed in major centers around the world, in vehicles known as exchanges. With the advent of changes in Communications and the globalization of markets, these fixed locations are now subject to change in terms of the new Services that the marketplace now requires.

The first Service the market provides is liquidity, which allows transactions to take place in an orderly fashion. The orderly nature of market transactions makes it possible for market participants to read market activity, which, in turn, leads to the single most important Service provided by the market: information.

Information on transactions is vital to all traders and needs to be disseminated on an on-line, real-time basis so that market activity can be defined with volume. There are three necessary elements in a complete market information source, or matrix data base: price, time and volume. These should be provided in a flexible format, as they have occurred and are occurring in the marketplace. As this information is disseminated to more people, the markets tend to expand, serving the industry in a better, broader fashion.

IS AN ORGANIZED MEDIUM

The most revealing aspect of the market is the fact that it is naturally organized, not chaotic (as it appears on the

surface). The key to this organization is the negotiation process used by market participants. What takes place in the negotiation process is the development of three reference points: the trade price, at which trade is consummated, and reference points above and below the trade price. The reference point above the trade price is apparently too high; the reference point below the trade price is apparently too low.

In a more complex negotiation process, we have another structure that gives further organization. This is the auction process. In this Situation, instead of a single buyer and seller, there are multiple participants who would like to buy or sell. This is also a known procedure for finding a single buyer and seller in a competitive format. In the auction process, if we have ten people interested in buying at a certain price, as the price moves higher, participants will drop out. For example, if an item is priced at \$10 with ten buyers interested, if the price moves to \$15, we may have six buyers interested; if the price moves to \$20, we may have two buyers interested; and so on, until the transaction is finally consummated.

Two types of auctions take place that may be confusing to the uninitiated: the down auction, in which multiple participants wish to sell, and the up auction, in which multiple participants wish to buy. In either case, the market is ordered around the fact that as price moves, it rations the activity of people wishing to buy or sell; activity is shut off as the price moves either higher or lower.

THAT EXPRESSES HUMAN BEHAVIOR

This refers to the use of the market by participants. Market development, which is the continual use of the market

during its time frame (that is, its trading hours), consists of six things: a current price; a reference price that is too low; a reference price that is too high; a price area that is recurring; any change in any of these; and the relationship of each element to the others.

From a small cell, not unlike John Schultz's minimum trend, the unit that includes each of these six elements will evolve from relative instability at a small sample size to relative stability as the market develops. That is, the reference points will become more stable and reliable as the process continues.

The weakness of past market theories, and the reason they have been largely impractical, is their failure to consider human behavior. The most important point past market theories have missed is that *human behavior is never balanced*. Because this is so, opportunities can be defined in any marketplace. Individuals and corporations in industries outside of the financial community do this every day, yet, amazingly, this basic concept has never been applied to exchange markets.

In essence, human behavior in the market is price/time allocation, which is affected by each of four major kinds of group activity. They are: confident activity; hesitant activity; gradual change; and beginning and ending activity occurring simultaneously in the same price area.

There are also three main groups of market participants, each of which affects human activity in the marketplace in a different way: the local Professionals, the commercials, and the general market participants. We've discussed these groups in detail elsewhere in this book.

IN DIFFERENT PRICE AREAS AT A GIVEN POINT IN TIME

By "different price areas," we refer to the range of distribution of prices in which all market activity takes place. The range of this distribution is important, and it gives the market a time parameter. The relationship can be defined in this way: The larger the range, the longer the market will remain in that price area since it will take the market longer to unwind. By the same token, a small distribution gives one a small amount of time, as the market can unwind more quickly.

Two other components that add to the stability of a distribution are the diversification of participants and the amount of trading volume. For instance, if we have a large distribution with a diversified clientele of market participants, then the market is probably in a rather stable condition. However, unstable conditions can arise in the same general framework if we find that the large, diversified clientele was operating from a single motive; when this motive disappears, the market may unwind very quickly. By the same token, if the diversified clientele is replaced by a single operator causing a large price range and volume the stability of the market may again be weakened.

In our analysis of the market, we are dealing with the present tense—conditions that exist and are evolving now. Our On-line data base gives us price information from the past up to the present, defining the current point in time and any changes taking place in it.

ALWAYS PRESENTING AN OPPORTUNITY TO SOMEONE

There are three time frames in any marketplace: the market-imposed time frame, defined by the operating hours of the exchange; the participant time frame, which is the individual trader's time frame for buying or selling; and the opportunity time frame. The opportunity time frame is a moment in the market that forces a participant to act because of the favorable price opportunity it offers. -

In the past, there were two main types of traders: day time frame traders and beyond-the-day traders. Day time frame traders are simply looking for a fair price. Those who trade beyond the day are more distant from the market; they are not interested in trading unless a very favorable opportunity is presented to them.

As the markets move toward 24-hour trading, the first two time frames are taking a smaller role, and the opportunity time frame trader is growing in importance. Today's opportunity time frame trader is distinguished from the beyond-the-day trader by the fact that the opportunity trader must watch the markets closely and continually, to ferret out the opportunity that may arise at any time. So he is closer to the market and follows it rigorously, knowing that he may want to trade at any time of the day or night—whenever a trading opportunity may arise.

The emergence of this new type of trader is contributing to the volatility of today's markets. He generally follows one of two behavior patterns: If the market gets too far away from him, he may conclude that he will have the opportunity to do just as well a day or two down the road, and so he will wait patiently; or, if he has just missed his best price opportunity by a small margin, he may follow

the market and buy at a price away from the best opportunity.

The purpose of the market is to serve society by bringing more people into the distribution System. The larger the distribution and the greater the portion of society using it, the more effectively the market will serve as a medium for change. Thus, it is important for the market to increasingly attract participants who are already active in the market (increasing the use of the marketplace) as well as attract new participants from the outside.

The Steidlmayer theory of markets draws together, in a simple form, many of the conclusions I've reached as a result of my years of practical work in various markets. I think you'll find it a useful framework within which to organize your own thinking about markets and how they work. Trading practices that are based on a sound understanding of market activity are likely to succeed; those that are not soundly based may work for a time, but, as markets change, they will no longer apply. Without a fundamental market understanding, you will lack a solid foundation from which to make the necessary adjustments. Thus, any trader can/benefit from learning and applying this theory in his daily work in the marketplace.

9

The Steidlmayer Distribution

The building block of any market is its distribution—the basic unit of market movement. Although the term "distribution" had been associated with markets, the nature of market distributions has never been fully examined. In this chapter I'm going to discuss a new type of distribution called the Steidlmayer distribution, which is quite different from the more familiar, so-called normal distribution.

PURPOSE OF MARKET

To understand the market naturally it is necessary to find its purpose. The real purpose of any market is to *distribute*, which is also its economic function. Any number of people trading among themselves without this purpose would not be serving society, and the marketplace would be doomed to failure. Trade facilitation is a measurement of activity that defines this purpose because it is volume. All activity takes place within a distribution. Just think of distribution as you would a Company's market share. The purpose is to penetrate the market and gain an increasing share. The volume of activity would describe this.

Also, try to think of the different support groups the Company has in order to maintain and enhance its market

Steidlmayer on Markets

share—warehouses, advertising, research and the like. Analyzing any of these critical parts gives insight into the strength or weakness of the distribution. This represents the natural flow of Information and we want to take the same approach to the markets. In other words, we want to be *inside* the workings that support the market.

THE NORMAL DISTRIBUTION VS. THE STEIDLMEYER DISTRIBUTION

As you know, in the normal distributions, variables cluster around an average, or mean, value. When a normal distribution takes place in the market, prices center around the mean. By contrast, in the Steidlmayer distribution, prices develop a range. In a sense, a normal distribution is past tense, representing the filling out of an already discounted distribution, whereas the Steidlmayer distribution represents the present tense development of an ongoing distribution. Later, it will usually be accumulated into a normal distribution pattern.

Thus, a trader who is looking for the Steidlmayer distribution can have timely Information from which to trade, rather than late information. He has a far more efficient tool with which to take advantage of price when putting on a trade because he can take advantage of movements in the market on an informed basis. The Steidlmayer distribution lends itself to opportunistic trading, for it presents a defined beginning or ending from which development evolves.

This phenomenon represents, I believe, the long-sought explanation of how Professional traders can make money in what most academics believe is a totally efficient market.

The Steidlmayer Distribution

The Steidlmayer distribution is what all good traders perceive, although it has not been fully expressed or explained before. For a trader to have been consistently successful for a longer period, he must be doing something right. The Steidlmayer distribution offers the explanation.

ILLUSTRATING THE STEIDLMEYER DISTRIBUTION

It's probably easier for us to give you a visual explanation of this type of distribution than to explain it in words. Look at Figure 9-1, which shows four days of Market Profiles for December 1988 T-bonds. Note the distinctive shape that characterizes several of the distributions shown in this chart. (We've highlighted it by superimposing an outline on the distributions.) As you can see, the Steidlmayer distribution can be described as resembling the letter /, a fishhook or a teardrop (either right side up or inverted). The size of the distribution can vary, as can its time frame. And the distribution may start from either end, though not from the middle. That is, development follows either from a first Standard deviation or from a third Standard deviation—never from a second.

In a normal distribution, the first Standard deviation appears in the middle of the range, with the second and third deviations falling above and below this median. This is the basis of the efficient market theory that a price away from value will always tend to move back to the center. This does occur in the marketplace, but only in a non-dynamic market, where there is no development. So the efficient market theory is not wrong; it just doesn't apply very often in real markets. The Steidlmayer distribution is far more common in dynamic markets where development is taking

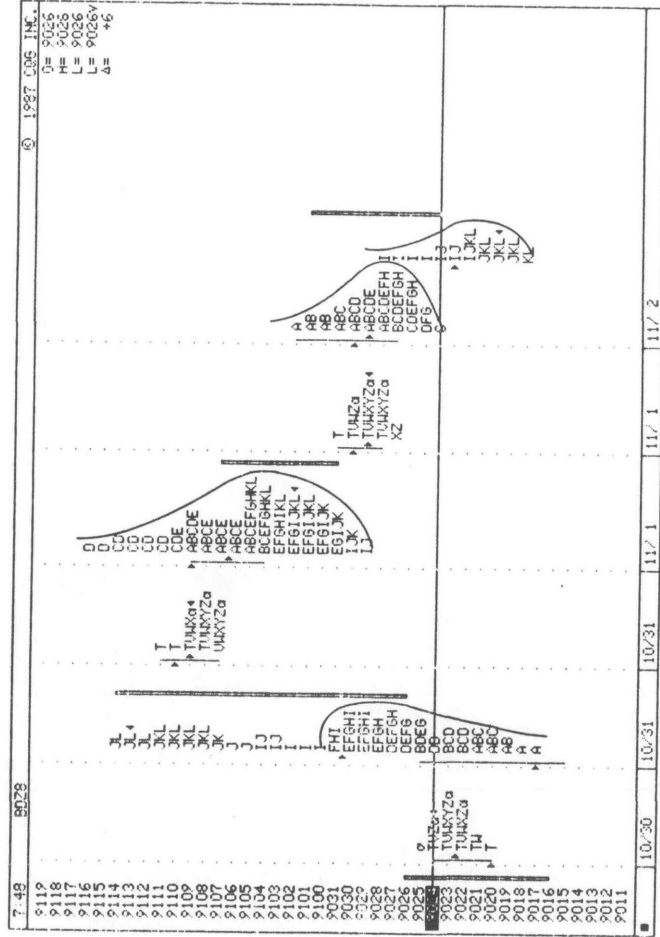


Figure 9-1. Four-day profile for December 1988 T-Bonds. Note the characteristic “fishhook” shape of the Steidlmayer distribution for October 31, November 1, and November 2. Note, too, that November 2 includes two separate distributions, each a Steidlmayer distribution.

place. Traders can sense the existence of either type of distribution.

THE STEIDLMEYER DISTRIBUTION AND SPEED OF MARKET MOVEMENT

Parts of the Steidlmayer distribution have the characteristic of being initiating or responsive in relation to the developing distribution — initiating in the second and third Standard deviations, where the market moves quickly, and responsive in the first, where it moves slowly. This volume relationship gives us the speed of market movement, as the market will move quickly away from the third Standard deviation but slowly away from the first.

Another benefit of recognizing this distribution is that it contributes to the natural flow of information — information that is indisputable, since the market is clearly either distributing or not distributing at any given time. The range of this distribution, along with the diversity of ownership and volume, gives us time; the greater the range, the diversity and the volume, the more time we have.

Just imagine the ability of a distribution to unwind, and you will see the premise. Suppose that a hundred traders around the world buy soybeans, and the market moves up eight cents a bushel. The market pauses in its distribution, and a few people decide to buy the pause, while a few others decide to take profits. Under these circumstances, the price will probably stay in the same general area. However, in the same Situation, if we suppose that all of the one hundred traders had the same purpose — say, to cover shorts — the same distribution could unwind fairly

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quickly. More rapid price change could then be anticipated.

Another example: Suppose we have one hundred people buy the market, and the range is only a cent. If the market stops and moves down, with all these people under water, many of them will sell at once; so the one-cent range hasn't given you much opportunity for free exposure in the market. Although the participation was diversified, the small price range limited your opportunity to trade.

The existence of the Steidlmayer distribution has been obscured by the fact that the larger time frame distribution often takes the appearance, after the fact, of a normal distribution. However, this is usually made up of several distributions that are profiled as one. In looking at this conglomerate, a trader is not getting pure, fast information but a blend; and a trader cannot successfully use blended information without making some adjustments.

Working with pure information is the best way to build a data base and adjust to changes in the markets. I am currently working with two large vendors to build an entirely new matrix data base that will allow the user to arrange data to yield pure information, including the elements of price, time and volume. This will allow the trader to become even more closely involved in the markets than ever before, enhancing his ability to "feel" market conditions as they develop.

A NATURAL PATTERN OF DEVELOPMENT

Let's step away from the financial markets for a moment and look at how the Steidlmayer distribution may apply in other fields. It's possible that this type of distribution can

The Steidlmayer Distribution

help us visualize activity and development in many other areas. For instance, let's visualize the "distribution" of the skills of a good, young trader as they develop throughout his career (see Figure 9-2).

In Figure 9-2, the vertical axis represents the skill level of the trader, from lowest to highest. The letters represent his level of attainment from the earliest period of his career (letters A and B) to the latest period (F and G). As the trader begins his career, he gains understanding of the market and of himself. His abilities grow, and he "distributes" or moves away from his beginning base to a new, higher level. This may take six, eight or ten years.

Now he is more relaxed and self-confident, and as some new opportunity emerges, he enters a second phase of growth—a further distribution up. Now he is at the 22 or 23 year mark in his trading career. At this point, around the age of 45 or 50, he is likely to top out. He has arrived in terms of his career; he has assets and a family, his desire has diminished, he is comfortable and less "hungry." There

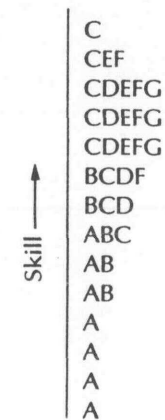


Figure 9-2. "Distribution" or development of the skills of a trader over time. His skill level increases, not in a straight line but with setbacks and advances, until the age of 45 or 50 (letter F and G), at which point development slows or ceases.

Steidlmayer on Markets

is no distribution away from this point; the trader's development has slowed.

Note the shape that has emerged: the characteristic fish-hook shape of the Steidlmayer distribution. The ups and downs that a typical trader experiences—the growth he experiences and the setbacks he learns to overcome—can be charted in a pattern similar to the one we see in the market.

Figure 9-3 shows another pattern by which a trader's skills might develop. In this case, the trader attains a higher level of skill only late in his career. Thus, the latest portions of the profile—represented by letters F and G—are at the upper end of the distribution. In Figure 9-2, the Steidlmayer distribution began in the third Standard deviation, then moved on to the second and the first. In Figure 9-3, the reverse pattern appeared: The distribution began in the first Standard deviation, then moved on to

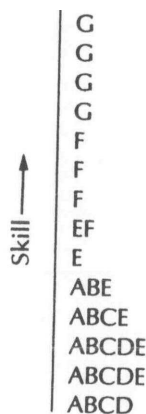


Figure 9-3. Alternative profile of development for a trader. In this pattern, the trader does not attain significant growth in his skills until late in his career. The same Steidlmayer distribution pattern appears, but this time starting in the first standard deviation and ending in the third, rather than the other way around.

The Steidlmayer Distribution

the second and the third. These are the two classic patterns by which the Steidlmayer distribution normally develops.

Note that the life history of an individual may contain more than one distribution. For instance, a trader might enter some other career at the age of 45 and so begin a second distribution, which itself would be likely to take the form of a Steidlmayer distribution. This mirrors the way in which a market may contain more than one Steidlmayer distribution during a single trading Session.

A similar kind of pattern could be traced in the career of a Professional golfer, the sales of a Company or many other natural patterns of growth and development (see Figures 9-4, 9-5, and 9-6).

An even more meaningful comparison might be to look at the development of the economy of the United States or any other country. We can expect a form similar to that of the Steidlmayer distribution to appear here as well. Change in any environment creates a development that may be measured or defined with the same underlying

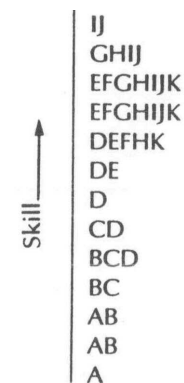


Figure 9-4. Possible profile of the developing skills of a Professional athlete over the first eleven years of his career (A-K). A more-or-less steady improvement is followed by a plateauing period during the last few years of the distribution.

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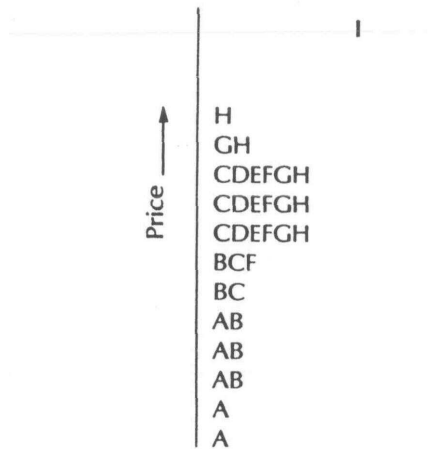


Figure 9-5. Possible profile of the stock price of a Company as it grows in value over a period of years. Note the price at I: this represents the markedly higher price offered when the Company attracts the attention of a takeover artist on Wall Street. From this point, a new distribution will begin; it may distribute higher or lower, depending on various factors.

form. Of course, I am not personally qualified to analyze the relationship of the Steidlmayer distribution to all these areas of human endeavor; but my experience and knowledge strongly suggest to me that this type of distribution does apply to all forms of growth and development, an idea which others may wish to pursue.

Now that this essential building block of the markets has been discovered, many important topics can be more fully researched. These include the speed of the markets; distributions that can be pulled to the center; cumulative change factors that lead to larger moves; net balance factors that abort apparent moves. Partly as a result of this discovery, the years ahead promise to be an exciting time for research into the nature of markets.

The Steidlmayer Distribution

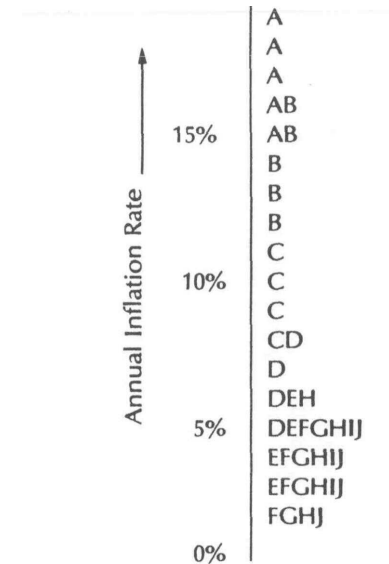


Figure 9-6. Possible distribution of inflation rates over a ten-year period (A-J). The early years are high-inflation years, much like the late 1970s in the United States. These are followed by a series of years characterized by stable price levels and low inflation, like the years of the Reagan Administration. Eventually, a new distribution will begin.

Natural Volume

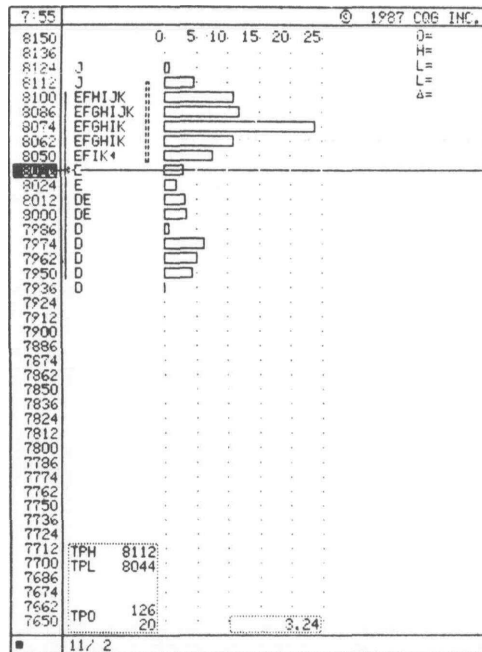
Volume is the track that traders leave when they use the market, not unlike the tracks hikers leave when they use a trail through the woods. Volume tells the story of market activity—the use of the markets.

READING VOLUME DATA

Even/without being presented in a carefully designed format, volume falls naturally into an organized form. In some markets, this form happens to be the same as the bell curve—the normal distribution. This is one of the reasons why the bell curve of price/time relationships, which is essentially a volume profile, takes the form it does. When the market is in a responsive mode, it distributes around a high-volume price in a virtually symmetrical fashion.

By contrast, when the market is in an initiating mode, the volume profile shows small, approximately equal volumes at each successive price. This indicates that the market has yet to find the fair price it is seeking. The market is looking for a responsive zone, but has not yet located it (see Figure 10-1). Thus, volume reflects the mode of activity of the users of the market and describes the condition their use is giving to the market.

Steidmayer on Markets

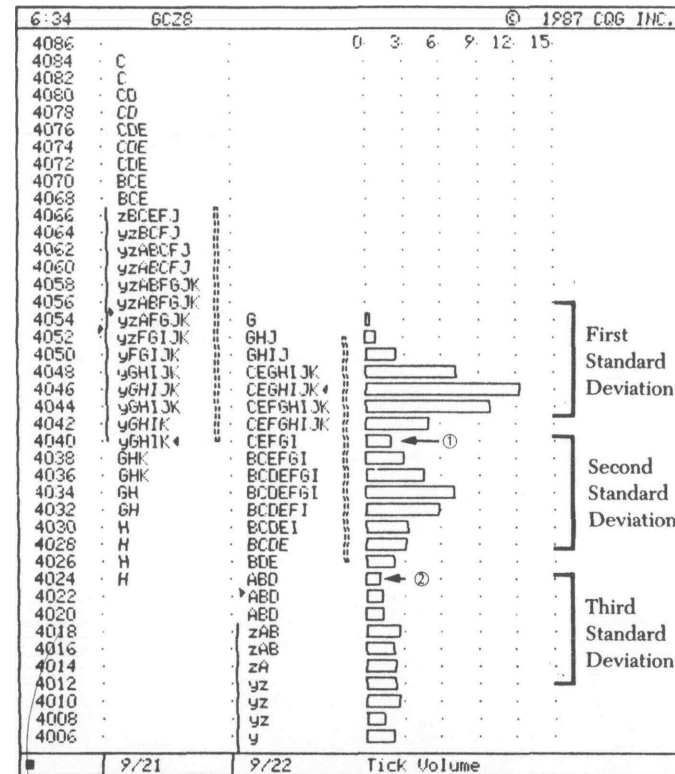


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Figure 10-1. Volume profile for January 1989 soybeans. The line across the profile divides it into responsive and initiating segments. Above the line is the responsive part of the market. Note the symmetrical pattern of volume, centered on the high-volume price (8074), with the same number of price ticks above and below. Below the line is the initiating portion of the market. Note the small, approximately equal volumes at each tick. Note that responsive area is the same as it was in the 1960's.

Volume also reveals the points of inflection of this behavior as it changes. A point of inflection is an area in which a change in the behavior of the market is taking place. It is characterized by relatively low volume in comparison to the developed range (see Figure 10-2). In a larger context, a low-volume price area similarly indicates the beginning and ending of market distribution.

Natural Volume



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Figure 10-2. Note the points of inflection (arrows), indicated by low-volume price points. These are areas in which a change in market activity is occurring. Points of inflection indicate change in market activity.

As we've previously noted, large or small volume in a distribution gives us a time reference. So does concentrated or diversified participation. Volume is organized naturally into three Standard deviations, with about two-thirds of the volume falling into the first Standard deviation, another quarter into the second Standard deviation

Steidlmayer on Markets

and the remaining 5 percent or so into the third Standard deviation. This pattern can give us insights into the probable speed of market price movements and how long the market will probably remain in a given price area.

The procedure is as follows: Let's assume that we will have 100,000 contracts of a particular commodity traded during the day. Let's also assume that we can correctly place a trade price area in the third Standard deviation for a given distribution. Finally, let's say that the market has just traded 4,900 contracts in this area. If these assumptions are correct, we can *know*—not just hypothesize—that the market must quickly move out of this price area. It has no more room to trade (see Figure 10-3).

Conversely, suppose we put this price area into the first Standard deviation of volume. If we've traded 40,000 contracts at this price, we now know, if our assumptions are correct, that the market will stay in this price area for a while—specifically, until it reaches a volume of around 68,000 contracts—before it moves out.

Note that this doesn't mean that we know which way the market is going to move; we know only whether it is likely to move or stay put, and, if it is going to move, how quickly.

Look at Figure 10-4, a real-market example that closely resembles the hypothetical profile shown in Figure 10-3. In this example, the prices at the upper end of the profile constitute the first Standard deviation of volume for this distribution. When the market was trading in this area, it was likely to remain there for a while. The prices below this point represent the second and third Standard deviations. A price in the third Standard deviation area represents an opportunity for the trader, since it could be assumed that the market would move relatively quickly away from this price and begin a new distribution.

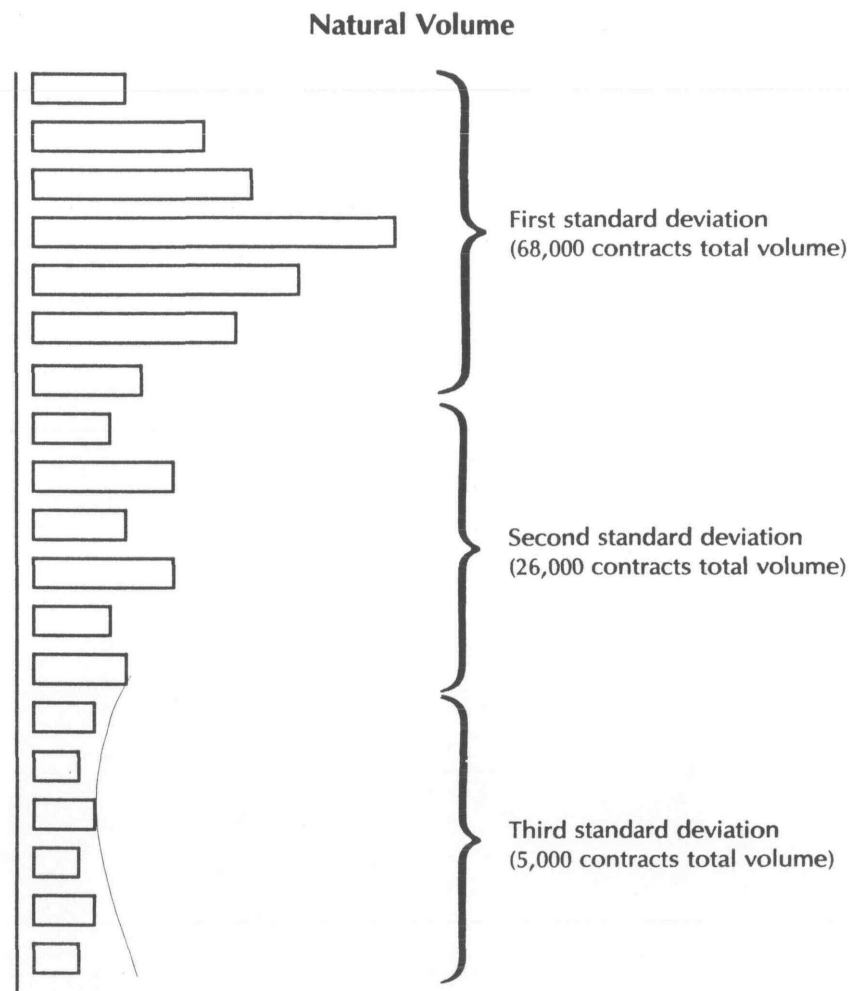
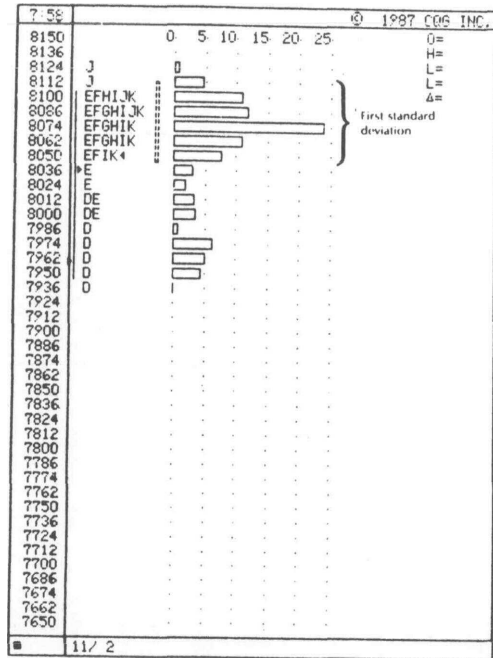


Figure 10-3. A hypothetical volume profile, showing first, second, and third Standard deviations. The assumption is that 100,000 contracts will be traded for the entire session. This pattern can be used to draw differing conclusions about the expected speed of market price movement, depending on where in the range the market is currently trading.

When the market is trading in the first Standard deviation of volume, it is in a responsive mode, trading around a fair price. When the market is in the second or third

Steidlmayer on Markets



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Figure 10-4. Volume profile for January 1989 soybeans. Note that a new distribution has begun in J-K time period. Note that new distributions do not necessarily start with the next day's opening.

Standard deviation, it is in an initiating mode, moving to find a fair price.

VOLUME AND THE STEIDLMEYER DISTRIBUTION

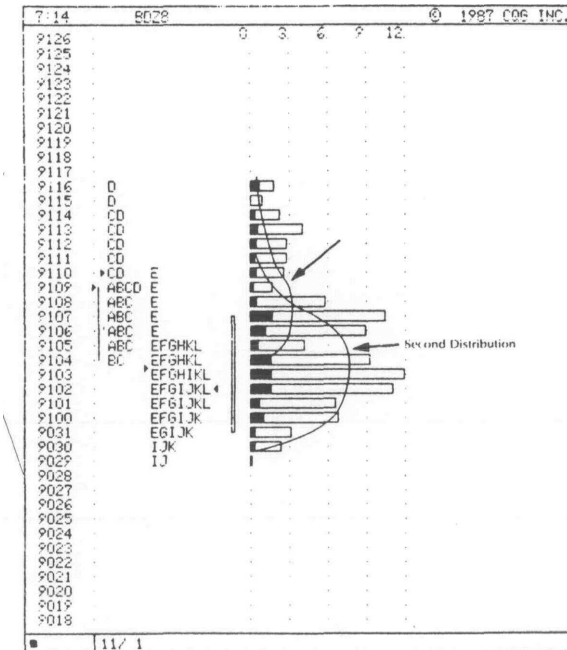
In the so-called normal distribution, the first Standard deviation appears in the middle, around the mean price, with the second and third Standard deviations tailing off above and below. In the Steidlmayer distribution, the first stan-

Natural Volume

dard deviation may appear either at the top or the bottom of the profile. Furthermore, the market may develop in either of two Orders: either first Standard deviation, second and then third; or third deviation, second and then first.

Consider Figures 10-5 and 10-6 for two more examples of how the Steidlmayer distribution is reflected in the volume profile.

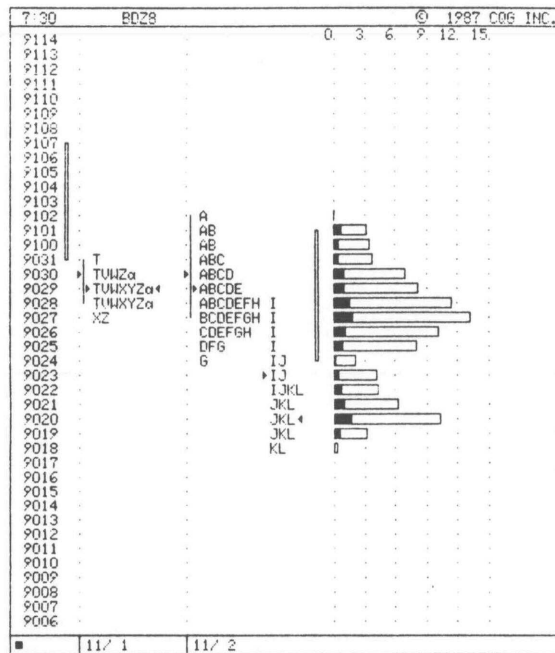
In Figure 10-5, two Steidlmayer distributions occurred during the same trading Session. To indicate the two distributions, we've superimposed outlines of the characteristic "fishhook" shape over the volume profile. The first



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Figure 10-5. Volume profile for December 1988 T-Bonds, showing two Steidlmayer distributions in a single day. The first occurred during the A-D periods, the second during E-L.

Steidlmayer on Markets



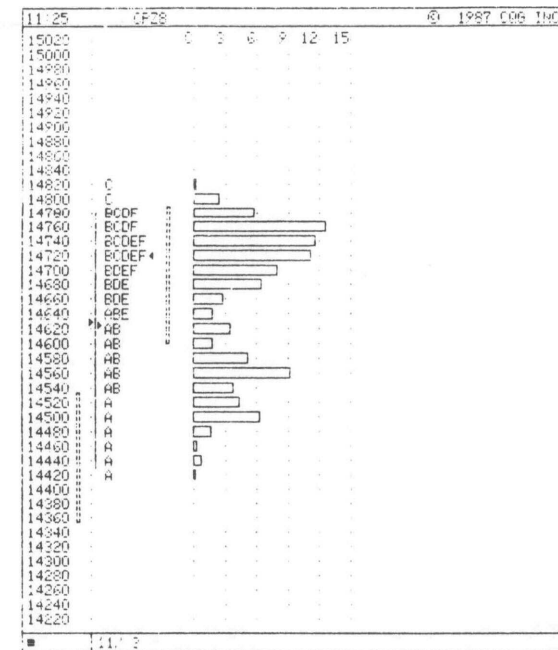
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Figure 10-6. Volume profile for December 1988 T-Bonds, showing another two-distribution day.

distribution developed in the Order of first Standard deviation, second and then third, ending at the higher end of the price range. The second distribution developed in the order of third Standard deviation, second and then first, ending at the lower end of the price range. Thus, the trading day as a whole contained one up distribution and one down distribution, resulting in a basically balanced overall picture.

In Figure 10-6, the profile for November 2 shows rather clearly two Steidlmayer distributions. In this case, both are down distributions.

Natural Volume



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Figure 10-7. Volume profile for December 1988 copper. The profile shows a nearly complete Steidlmayer distribution, with significant volume at the high end of the price range. If you were long copper, you'd like the low-volume number at 14600 to hold as the trading Session continued and you'd like a new distribution to begin to the upside.

KEY POINTS IN ON-LINE VOLUME DATA

After putting on a trade, it is very important to be able to recognize the kind of market activity you are getting and describe it with volume. The key to reading on-line volume is to note as soon as possible any single price that is accumulating a large amount of volume. This is a strong indication of a responsive Situation or the likely presence of a first Standard deviation of volume.

Steidlmayer on Markets

On the other hand, a series of small, almost equal price volumes with a correspondingly large range means that the market is in a second or third Standard deviation, seeking to find the first.

In analyzing on-line volume, then, the most important numbers to look at are the high-volume number and the low-volume number because these will be relatively hard to change. But they do sometimes change, particularly when you are working with a small sample size early in the day. Under those circumstances, one large trade or a single influx of trades can change the Situation dramatically. Changes of this sort are essential to note, and their meanings must be analyzed for any possible impact on your trading position (see Figure 10-7).

On-line volume is not available at the present time for many exchanges; tick volume may be substituted for it. Volume figures released after the close by the Chicago Board of Trade in its Liquidity Data Bank, as well as the partial releases during the trading session, provide valuable information relating to continuation or change.

The extension of availability of on-line volume data will be the most significant and beneficial development in the industry over the next several years. As exchanges become increasingly aware of the importance of their role as sources of market information, and as traders come to realize the benefits of trading with volume and using volume to describe market activity, there will be a natural evolution of volume information brought on by demand.

Reading Market Activity

The key to reading the market is knowing and understanding the basic structures of market development: the negotiation process and the distribution process.

THE NEGOTIATION PROCESS AND THE DISTRIBUTION PROCESS

The negotiation process starts the market; development follows. The procedures of the negotiation process itself are familiar to all who work in and around markets. There are three crucial points in any negotiation process: the trade price and two outside reference points. These points evolve together into the development of the market, almost like an egg growing into a chicken.

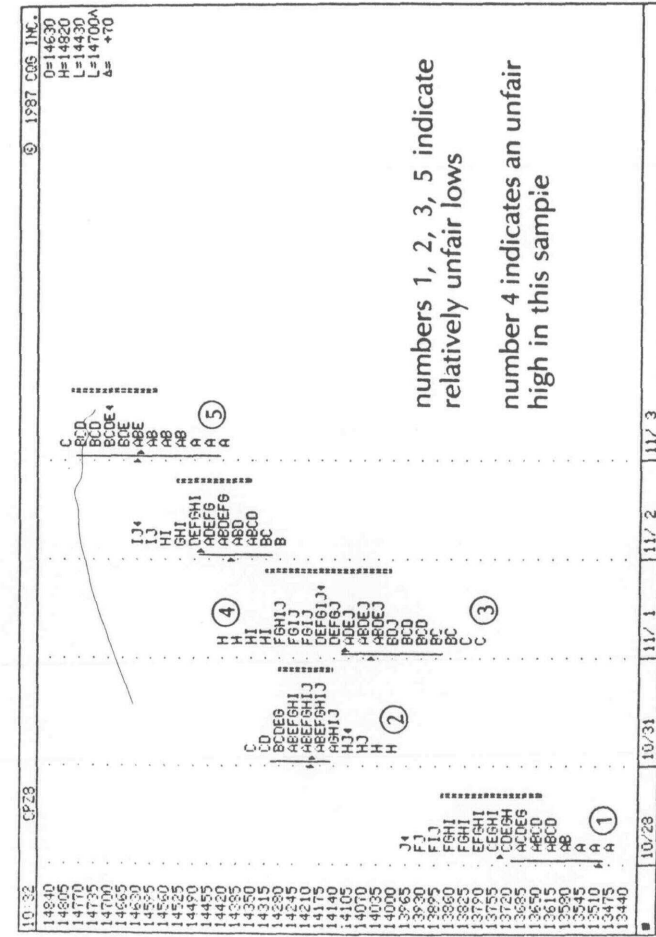
This development includes six important elements or reference points: the starting price; the current price; the two boundaries of the day's range (that is, the current high and low for the day); the recurrence of prices used (that is, the accumulated trade area); and the relationship among the elements. These six elements may develop in any order; they may also change in any order. These elements and their interrelationships evolve in a continuous, forward-rolling process throughout the trading session. As the

data build and the sample size becomes larger, the reference points become more stable, or, in some cases, more clearly defined.

Any single reference point may be used or studied separately, but it is better to use it in relation to the others. For example, a reference point that is greatly out of proportion to the other indicators may not mean much by itself; but once the comparison to the other reference points is made, its significance becomes clear (see Figure 11-1). All this activity takes place in a *distribution* or *ränge* for the day.

To begin reading market activity, try to place the various reference points into the different thirds of the market's *ränge* for the day—that is, the the top third, the middle third and the bottom third. Of course, once the trading session is over, you can easily see the top, middle and bottom third of the *ränge*. What you want is to be able to do this on-line, in the present tense—or as close to this as possible. For instances, being just a half-hour late in reading this information would be a high Standard of accomplishment, and one that would enable you to trade very profitably in most cases. As you trade, you'll find that you'll trade well when you've been reading the market accurately in the present tense; when you trade poorly, you've been unable to do this.

Having developed this activity to some degree, the second key is to realize that all market activity takes place within a distribution. Therefore, you must relate the *ränge* you are looking at to the *ränge* of the distribution. Furthermore, you must give consideration to more than one distribution when looking at the *ränge* of the day. In other words, in order to read the market, you must read the current distribution along with all the distributions undertaken by the market during the current session—or, at



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Figure 11-1. Profile for five days of December 1988 copper, illustrating how reference points take on significance in relation to one another. Note the slight but continuing buying imbalance evident on four of the five days profiled. (The profile for November 1 is essentially balanced.) This means that the highest price for each day is somewhat more fair than the lowest price. Clearly, this could not be deduced by examining the prices in isolation from one another.

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least, be prepared to modify and correct your idea about the number of distributions as the day develops.

Notice the contrast between today's markets in the late 1980s and those in the 1960s. When I was first trading, a typical day would have only one quarter of a distribution; that is, it would take four or even five days for a distribution to complete itself. Today, during a volatile Session, we may experience three or four distributions in the same market, usually all in the same direction. This certainly illustrates the change in volatility that I've experienced since I started trading. Based on our currently available measurement tools this trend appears likely to continue for the near future and even accelerate, although it is sure to peak out eventually.

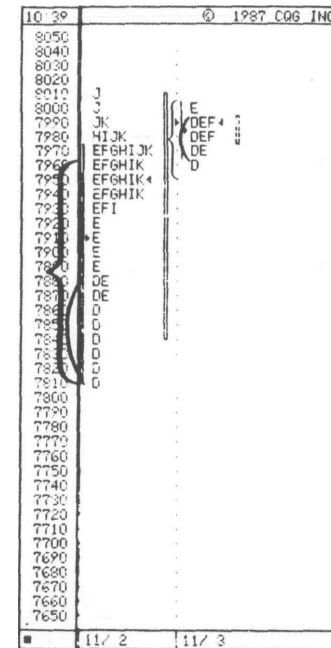
EMERGING AND DEVELOPING MARKET ACTIVITY

We can classify the market's initial development into two parts. The first part is emerging market activity, covering the immediate development of the market. It is concerned mostly with the degree of range distribution as the market develops.

Next comes what we call developing market activity. This is the price/volume relationship as it takes shape during the development of the distribution. Understanding it calls for placing price activity into either the first, second or third Standard deviation (see Figures 11-2 and 11-3). The price/volume relationship yields time and places price location as to potential development.

Last, we need to place these two forms of activity within the Steidlmayer distribution, so that we can read when this initial distribution is ending, and perceive the begin-

Reading Market Activity



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Figure 11-2. Two-day profile for November 1988 soybeans. Emerging market activity with a distribution evident on November 2, though not on November 3.

ning and ending of other possible distributions during the day. ^

ONE DAY IN THE MARKET

To bring this process to life, let's follow a real-life market as it develops on-line during the course of a single day. Figures 11-4 through 11-11 will profile December 1988 gold futures as they unfolded on November 3, 1988. Study the profiles and our commentary, and you'll gain some

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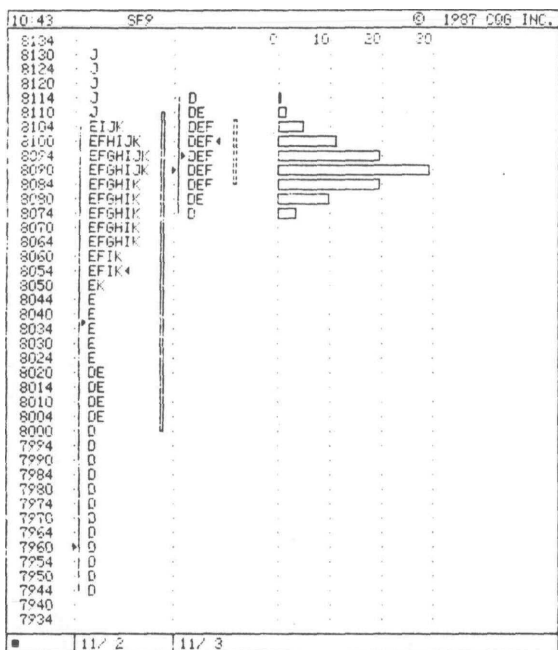


Figure 11-3. Two-day profile for January 1989 soybeans. On November 2, the market opened with a distribution; it was possible to place the early prices within the third Standard deviation. On November 3, with no distribution, we place price within the first Standard deviation. Note that volume confirms this.

insight into how an experienced trader can trace a market as it develops.

Figure 11-4 shows the profile for the four preceding days (October 28 through November 2) and for November 3 as of 8:00 A.M. Chicago time, about an hour after the market opened. Our reading of the emerging market activity tells us emphatically that there has been no distribution in the market. (Compare this with the profile for October 28, on which there was a large distribution at the opening.)

Reading Market Activity

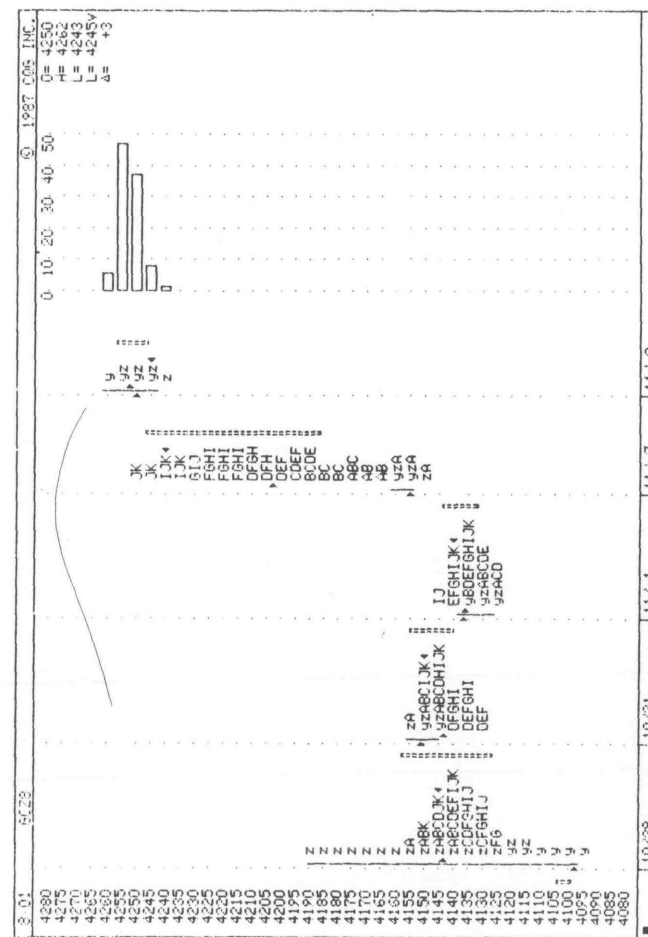


Figure 11-4. December 1988 gold as of 8:00 Chicago time.

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Note from the tick volume chart that we have two very large numbers, representing a high percentage of trade occurring at two prices; so we can comfortably place this price area within the first Standard deviation of volume. (If all the volume bars had been small and approximately equal, we couldn't make this assumption.) So the market is likely to remain in this price area for a couple of hours.

We can also see that the market is barely higher than the previous day, which had a major rally; so we can expect the market to trade within the value area of the previous day since there is no distribution either up or down.

Figure 11-5 shows the market as of 9:30 A.M. Chicago time. The market has basically remained within its original distribution range; it made a new high, but then went nowhere. We have deliberately ignored volume in this chart in order to follow and test our first reading. After the first half hour, you should have the developing activity in hand; learn to trust this reading. As of 9:30 A.M., we don't know any more than when we started out—but we don't know any less, either.

Figure 11-6 brings us up to 9:51 A.M. Chicago time. Again, we have left volume numbers off the chart. Now the market is beginning to take shape as an emerging Steidlmayer distribution—note the familiar fishhook shape. It's apparent that we may have completed the first distribution. We don't know the volume, since on-line volume isn't available; tick volume could give us a distribution of volume, but not a total. And we can tell that we are at the beginning of a possible new development. Having tested the high side and having gone nowhere, the market should now test the down side.

We have some slight support at the 423 area, where there is a point of inflection (a tiny one), labeled 1. There are three points altogether at which we can expect support:

Reading Market Activity

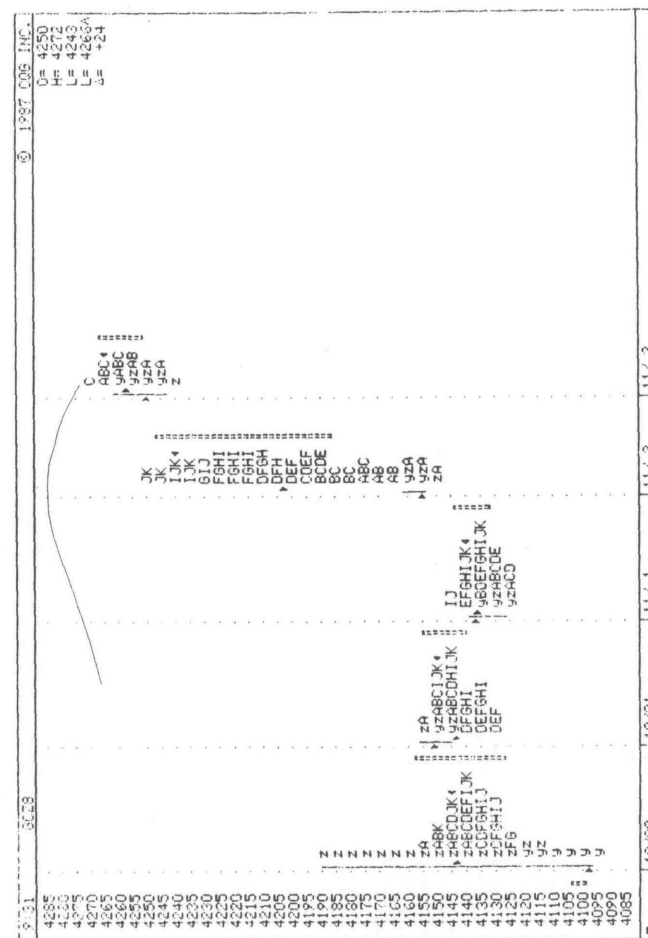
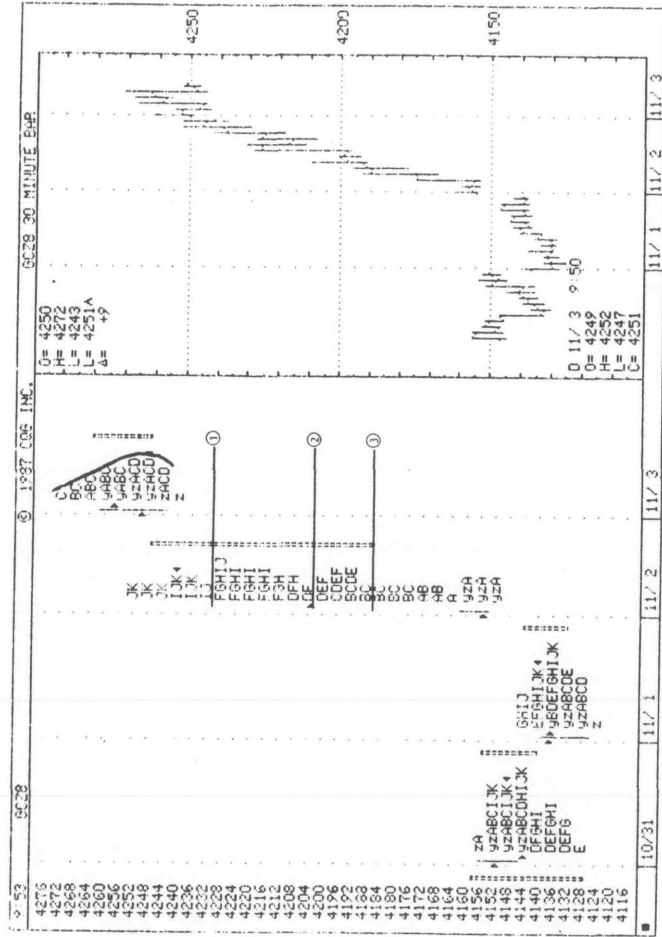


Figure 11-5. December 1988 gold as of 9:31 Chicago time.



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Figure 11-6. December 1988 gold, as of 9:53 Chicago time. Note the three possible support points — points of inflection or low volume numbers of past profiles.

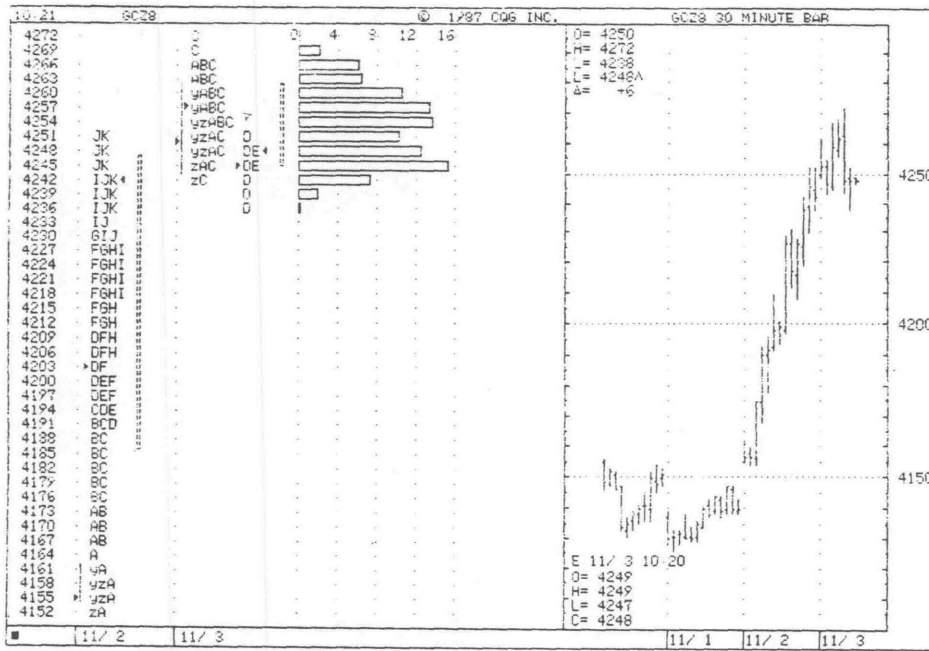
423 (point 1), 420 1/2 (point 2), and 418.8 (point 3). We've been expecting the market to trade within the value area of the previous day, so it's important to have our reference points within this area, not far outside it. (Note that we have no resistance areas on the top side; we'd have to look at data for the past month to find them.)

Now we're prepared for what we think is going to happen: a new development. Let's see what our next chart shows us.

Figure 11-7 shows us the market as of 10:21 A.M. We have now completed our first distribution—a weak distribution to the upside—and started a new distribution, beginning with the D period in the profile. The market held the first support area, a sign that the market isn't very weak. This attempt by the market to break marks the start of the new distribution.

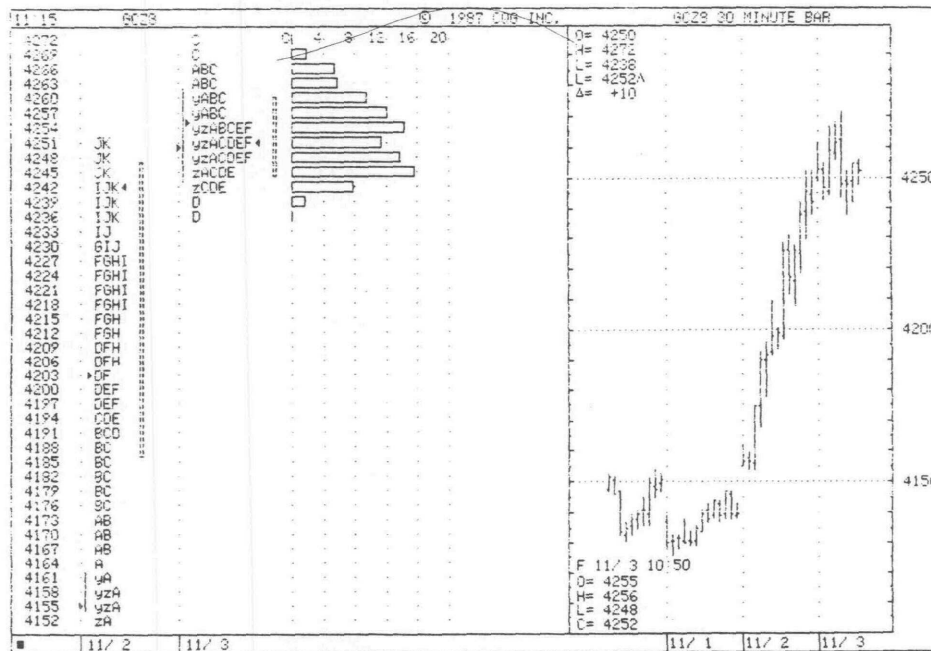
Tick volume data describes this new distribution. Note that there is no low-volume number between the first and second distributions; rather, the volume number third from the bottom of the volume distribution is actually rather large. If the market were going to have a significant distribution, it would be trading well below a low-volume number. That number would become a point of inflection between the two distributions and a resistance point that the market would have to get through in order to resume the uptrend.

In the absence of this pattern, the probe of the downside appears to be as weak as the earlier upside probe. We assume that this D-period distribution will prove to be the equivalent of the yz distribution we observed at the start of the market; we have a high percentage of trade at just a couple of prices, giving us much the same Situation. We conclude that the market should remain in this price area for some time.



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Figure 11-7. December 1988 gold as of 10:21 Chicago time.



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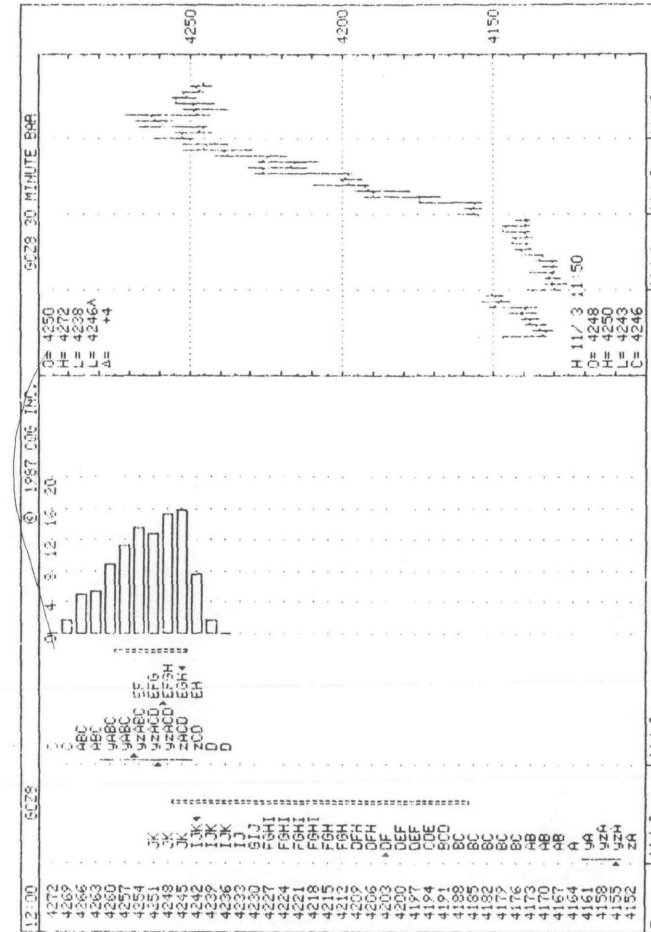
Figure 11-8. December 1988 gold as of 11:19 Chicago time.

We pick up the market in Figure 11-8 as of 11:19 A.M., and our reading seems to be holding correct. However, we are now building, in a long time frame, a large first Standard deviation of volume. We should move out of this by the end of the day to complete the larger-time-frame, day distribution of first, second and third Standard deviations. We expect the market to move out of this area, to either the up or down sides, sometime during the last hour of trading.

An aside for Market Profile traders: this is a neutral day. It is balanced, with about equal distribution on both sides, and the market is currently around the middle of the range. Had the opportunity time frame traders been active when the market failed to rally or break, and had they thought it was the best opportunity they were likely to get for the next several days, they could have driven the market disproportionately away from either extreme.

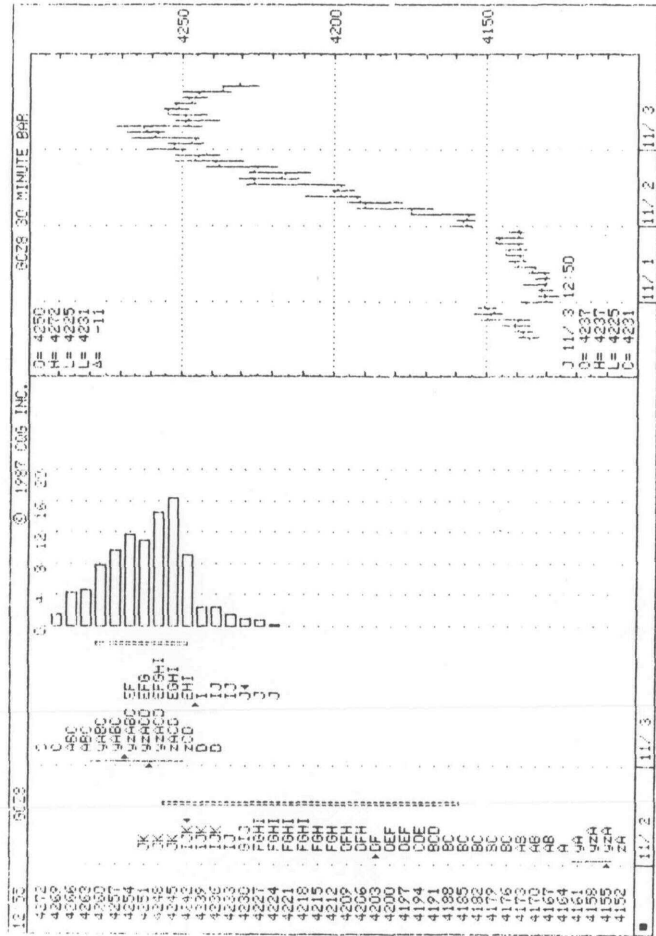
Figure 11-9 shows the market as of 11:59 A.M. We attempt to organize the market into distributions since we think there will be movement out of the first Standard deviation. Thus we break the market at what we think is the top and bottom of the responsive part of the first Standard deviation of the distribution that occurred during the *y* through *D* periods. This gives us a beginning distribution in *E* through 77 periods, which has all the earmarks of a first Standard deviation, much like what we saw at the outset of the market.

Figure 11-10 shows the market as of 12:54 P.M. We can see that in the last hour of trading (the 7 and / periods); the market did in fact complete its second distribution and moved down through the first support area. The 7 period stopped at 4232, the support level we mentioned earlier. Its target now is the next support area, around 420 1/2.



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Figure 11-9. December 1988 gold as of 11:59 Chicago time.



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Figure 11-10. December 1988 gold as of 12:55 p.m. Chicago time. The second distribution takes shape.

As the market distributed during this last hour, the volume percentages at the last six prices were all small and basically equal. This gives us the possibility of having a point of inflection between the first and second Standard deviation of volume in the second distribution. Now we have the market trading between 424 and 4188 for tomorrow's activity.

Figure 11-11 is the finished profile for the day's activity in this market. The profile has definition in that it displays a fair value price area, balanced activity toward either extreme, a range extension up and a range extension down, making this a neutral day. It also illustrates that the only net form of market activity was time/price opportunity selling in the fair value area, which was visible to us all day long.

Although this market didn't do much, it's a clear example of why I now recommend the natural form of market information as pure, fast and indisputable. The day's profile is one of normal distribution from 424.80—from the natural viewpoint it was two *distributions* that we could follow and note development. It is the strongest basis for a solid understanding of market activity in the present tense. YouV Market Profile information, of course, is a fine adjunct to it.

NATURAL INFORMATION FLOW AND THE SUCCESSFUL TRADER

The successful trader today is a highly individualistic creature. You don't trade in a group but as an individual. Your Personality, methods, time frames, needs—all are unique to you and cannot be shared by anyone else.

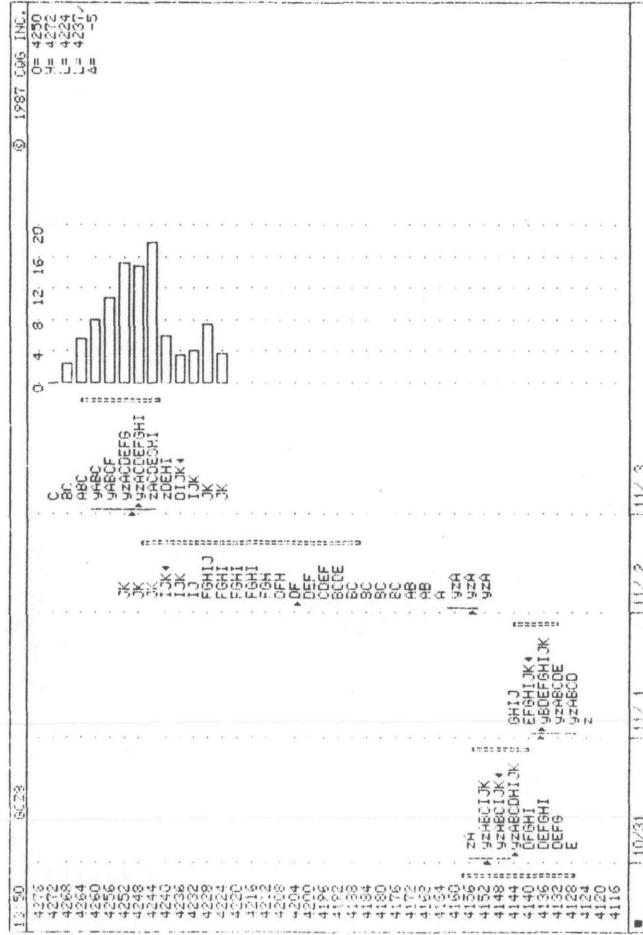


Figure 11-11. December 1988 gold: the completed profile for November 3.

The successful trader absorbs market activity and Information by participating fully in the markets. He perceives opportunities as they arise and makes distinctions among them, discerning which are more valuable, which less. The good trade doesn't escape him. He can turn his ideas into market opportunities because he has worked to learn, not learned to work.

Today, the trading environment is changing; it is expanding to different time zones in the new, growing, global marketplace. The trader cannot function in this new environment in the old, familiar ways; he has physical limitations, like the need for sleep and mental refreshment that would make this impossible. So the trader must learn to do the same things that have made him successful in the past, but in a new manner.

Now the trader can generally build his knowledge base by observing the time frames of market activity that he has missed in the past. But these observations fall short of giving him what he needs for his own, highly individualized data absorption program, from which the experienced trader is accustomed to deriving perceptions and opportunities. He needs to be able to break down market activity and define it with volume, just as it developed during the time frames when he was not personally available. He needs a way to participate without participating.

The solution is a data base with all the elements that the trader needs to play back the missing time zones in a manner familiar to him. The data base needs a highly flexible format to reveal the structure of the market—not according to rigidly fixed parameters but flexible ones—so the trader can arrange and format the data to meet his own needs and fit his trading style. He begins with the base unit of market activity—a distribution.

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As data of this kind becomes increasingly available, it will provide a base for industry growth and help foster world trade in a fair and competitive environment.

A BACKWARD GLANCE ... A LOOK AHEAD

In Part III of this book, we have discussed the natural organization of the market and how it works and considered the implications of the fact that market activity consists simply of human beings using the markets. We have given some insight into the kinds of human behavior exhibited in markets, and we have seen how market development can be captured, defined and monitored.

In the remainder of this book, we will apply this information to practical use by you, the reader, in your own trading practice.

Most trading books cover only mechanical methods or Systems, leaving the reader with a very limited and non-flexible base from which to develop. Instead, I'd like to take all the ideas we've discussed and use them to help you start on what I call the natural way to trade. It relies on the natural flow of information (understanding distributions) from the market, which, as I think you'll find, is far superior to any mechanical method, both because it allows for changing markets over time and because it provides a path for greater personal development by the individual trader.

PART IV

THE NATURAL WAY TO TRADE

Profile of the Successful Trader

Trading is being young, imperfect and human; not old, exacting and scientific. It is not a set of techniques, but a commitment. You are to be an information processor.

Your trading skills can be developed only by participating in the markets. You need to become a part of the markets, to know the state of the markets at any given time and, most importantly to know yourself. You need to be patient, confident and mentally tough.

The good trader offers no excuses, makes no complaints. He lives willingly with the vagaries of life and the markets.

Start by becoming capital safe so that you can participate in the markets on an ongoing basis. Position yourself so that you can't be knocked out of a market by a few setbacks. Continuous involvement prepares you to take advantage of any good opportunity that arises. It also contributes to your self-confidence. It creates a safe environment in which you can experiment and learn, knowing that no experience will be a career-ending one.

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As your trading experience grows, you will begin to gain a feel for the market that enables you to sense changes as they occur, not after. You will develop the ability to recognize opportunities rather than going after dreamt-up trades. You will learn to recognize when you are wrong even before your dollar position tells you so. And you will begin to see, time after time, that when you have exited a trade it was usually the right move to make.

In other words, you will begin to experience trading.

Now it is time to further sharpen and refine your skills — to work to learn. Try to develop a sense of the price/value relationship underlying the trades you make. You'll find that there are only three possible price/value relationships: price may be at value, above value or below value. If your trades are *not* buying a price above value or selling a price below value, your trading circumstances will be favorable; the effects of your mistakes will be muted, and it will be relatively easy to recover from them. Mistakes outside these Parameters can be disastrous and career ending.

In the early stages of your trading career, don't worry too much about whether you should buy or sell, but rather about how you've executed whatever trade you've made. You'll learn more from your trades this way.

Never assume that the unreasonable or the unexpected cannot happen. It can and it will.

Profile of the Successful Trader

Remember that you can learn a lot about trading from your mistakes. When you make a mistake—and you will—don't dwell on the negative. Take your lesson and keep going.

Never forget that markets are made up of people. Think constantly about what others are doing, what they might do in the current circumstances, or what they might do when those circumstances change. Remember that whenever you buy and hope to sell higher, the person you sell to will have to see some opportunity at that higher price in order to be induced to buy.

You will need a sound approach—one that allows you to win at trading. It's best to try to win on the grind: Plan on taking a small profit from a large number of trades, as well as a large profit from a small number of trades. Don't think of yourself as a take-off artist; rather, think of yourself as marketing an idea whenever you enter a trade.

Traders who lose follow one of several typical patterns. Some repeatedly suffer individual large losses that wipe out earlier gains or greatly increase a small loss. Others experience brief periods during which their trading wheels fall off; they lose discipline and control and make a series of bad trades as a result.

The wise trader makes many small trades, remains involved and constantly maintains and sharpens his feel for the market. For all of this work, he hopes to receive some

profit, even if it is small in dollar terms. In addition, continual participation allows him to sense and recognize the few real opportunities when they arise. These generate the large rewards that make the effort of trading truly worthwhile.

The program you follow must allow you to have reasonable positive expectations; it must make trading fun and exciting for you. If it does, you will find that the common complaints you hear about the anxiety of trading and the fear of pulling the trigger will not affect you. As your experience grows, your patience and confidence will also grow. You will learn to stand alone and to make the tough trades — but not the tough stupid ones.

Discover what you do well consistently as well as what you do poorly. Find a base and build on it. This is how the successful trader is made.

13

Trade Preparation, Execution and Monitoring

Although this chapter may appear complex, it is really very simple. All I have to say here can be reduced to two basic principles. The first requirement for a successful trade is a good idea. The second is to effectively place that idea in the market under advantageous circumstances. This is all there is to successful trading. We could stop the chapter right here, but instead, we will develop these two ideas in detail. As we do, however, you should always remember this simple beginning because everything else grows from it.

FROM AN IDEA TO AN OPPORTUNITY

Every good trade starts with an idea. The idea will exist in a sort of floating time frame in your mind, awaiting the circumstances that will transform the idea into an opportunity. In a moment, we will get into some definitions and requirements that will help you get started in developing ideas, but your ultimate goal should be to make the process nearly instinctive. Realize that it takes time to be able to consistently come up with good ideas; this is one reason

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we've emphasized making trades and participating in the markets as a necessary part of your training to become a good trader.

An opportunity can be defined in two ways. It can be defined as a price away from value or as an identifiable Situation that is going to change or continue. As we've already noted, there are three possible price/value relationships in the marketplace: price may be at, above or below value. You must learn to track how the current price is related to value at all times.

A related concept—which at first may appear to be the same idea—is the price/value conditions under which the market is currently operating. In a fundamental sense, value is equal to conditions. For instance, suppose a certain stock is priced at \$10 and is earning \$2 per share. Further suppose that the average multiple for the industry is five times earnings. Under these conditions, we can say that the stock is priced at value. Any change in these conditions would obviously affect the price/value relationship and could be taken advantage of by those who perceive it.

In order to understand the conditions under which the market is currently operating, we need to use our knowledge of all the relevant economic and other factors. Any number of facts, trends, conditions, changes or elements could be involved: a current increase in the demand for soybeans; a declining Standard of living, causing diminishing consumption of red meat; expanding global supplies of oil; political unrest threatening the continuing flow of gold and silver from South African mines—any of these, and many more, could change the conditions of the market. Tracking such changes is tedious, time-consuming work, but it pays big dividends in terms of sound ideas for trading.

Trade Preparation, Execution and Monitoring

An easier method of determining the condition of the market is to study a bar chart covering price data for one or several past years. Compare the present price location to the total, long-term range. Look at the price areas the market moved away from quickly in the past, and compare them to those areas in which the market historically spent the most time. This process will allow you to ballpark the current Situation; over time, with practice, you can acquire reasonable proficiency at it.

To get closer to the market, work on understanding the price/value relationship that the market is using or the conditions under which current opportunities are being displayed. There are situations in which price moves sharply away from value because of some surprising event; in such cases, the market usually falls back to value quickly.

More common is the Situation in which price and value move generally together, although not in perfect unison; one will move ahead of the other or fall behind for a short time. This can occur during the growing season of a crop. For example, during 1988, the summer-long drought affected the quantity and quality of the growing crops, causing a price increase. While the price was rising, the crop was deteriorating, so the value of the crop was increasing also. Thus, both price and value were increasing, although not always at the same speed. The difference between the two represents opportunity in the short term.

The third and last kind of price/value conditions is the one most favorable to the trader. This is the one in which value moves far away from price, either on the high side or the low side. Here is where you should try to make your few large trades with the greatest profits. Such circumstances arise rarely. When they do, it is due to the basic human tendency to avoid change. Because of this

innate psychological trait, people tend to overly discount news that should affect the markets. As market participants rationalize their observations of change out of existence, prices fail to reflect the current change.

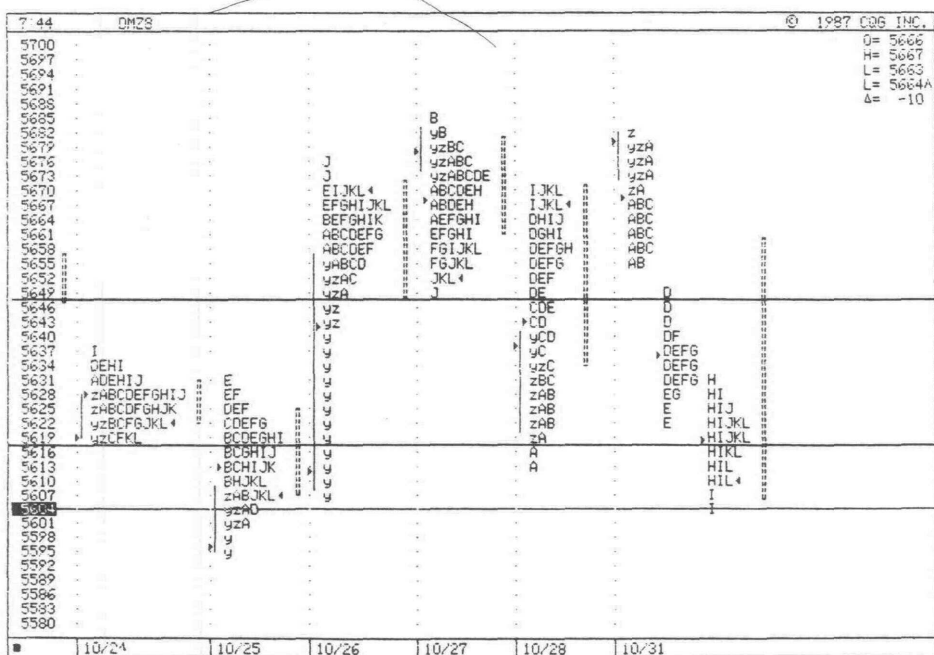
The inability to accurately distinguish among these three price/value conditions—or even to understand that they exist—causes the downfall of many traders. If you treat all of these conditions as if they were the same, you won't be successful for long. Conversely, recognizing these conditions when they arise can enable you to transform a good trading idea into a real opportunity.

PLACING THE TRADE ADVANTAGEOUSLY

Now that you have some sense as to how an idea becomes an opportunity, you need to learn how to find an area in the market in which can put on your trade at an advantage.

A curious phenomenon I've noticed in the markets, which I can't explain convincingly—and which I believe will change in the near future—is the fact that the market seems to start and stop at successive ending distribution or low-volume areas (see Figure 13-1). The underlying cause appears to be a lack of commitment or leadership in the marketplace.

I've also observed that when a market enters a distribution area, it tends to move to the opposite extreme. This has proven to be a very reliable phenomenon. It appears to be caused by the market's need to explore the activity at the opposite extreme to see which way it can go. (I would call this explanation an experienced guess on my part rather than a proven fact.)



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Figure 13-1. Six-day profile for December 1988 Deutsche Marks. The three lines represent low-volume points, which are also ending distribution areas or points of inflection.

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Whatever the reasons for them, we'll use these phenomena as trading guides until the markets tell us otherwise. They serve as useful reference points for implementing our opportunities. Whenever possible, we'd like to have three of these low-volume reference points above the market's emerging activity, and three below. This will allow us to take advantage of price as it reaches any of these areas. Three areas are usually enough to contain the current range; it may expand to more in the future.

The goal of the active trader is to take advantage of price without paying a premium to implement the opportunity. Because of the opportunity time frame, these are good reference points to use in dealing with opportunities that you may have missed. You may also find that, in an active, trending market, the market holds the first resistance area below; then, as it tires, moves to the third resistance point. You'll develop a sense of this as your experience grows.

Suppose you think there's an opportunity to buy soybeans. Your first opportunity is to buy them at 7.75. However, you pass up that opportunity, for whatever reason, and the market subsequently moves up to 7.80. At this point, you commit to the market. Having had the opportunity to buy at 7.75, you are now paying a 5 cent premium for the right to go long, which really wasn't necessary. So now you need the market to develop further, which it may or may not do.

If the market stalls, your trade will not be in as favorable a circumstance at 7.80 as it would have been at 7.75. If you consistently pay this kind of premium over a large number of trades, your desired small profit will turn into a small loss. Furthermore, you're missing the real goal of the trader: to take advantage of price opportunity. So learn from experiences like this, and develop the needed skills.

Trade Preparation, Execution and Monitoring

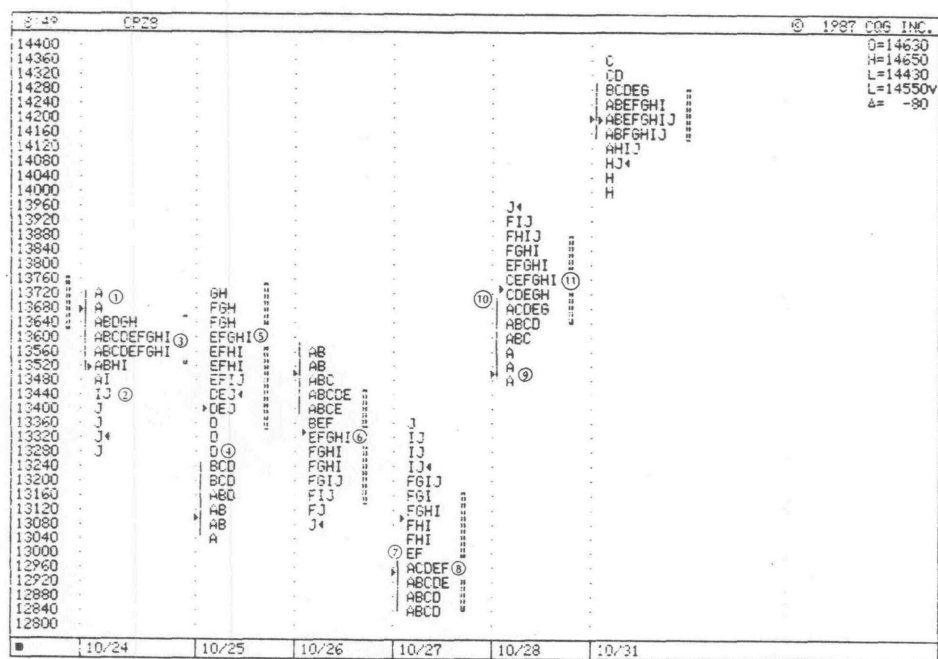
The next step in trade preparation is determining the activity of the long-term buyers and sellers. This is covered more fully in the Market Profile section of this book, but we'll touch on it briefly here.

There are three forms of activity by long-term traders throughout the range for any day: activity at the tops and bottoms of the range (extremes); activity that causes the market to move away from its first balance (range extension); and activity in the fair traded area (the TPO or time/price opportunity count). Take the last five days activity, and simply count the buying and selling activity in each profile. Suppose, over five days, you find ten forms of buying and three forms of selling, as opposed to ten forms of selling and three forms of buying. This would establish a distinct set of conditions in which to market your trade, and it may influence you to act immediately or to wait for better conditions (see Figure 13-2).

One point that many traders fail to grasp is the fact that major market moves occur rarely. Thus, the opportunities—and the dangers—that large price changes represent only appear a small percentage of the time.

Figure 13-3 offers a good example. This chart tracks about six months of price activity in the Japanese yen market. (A similar chart could be created for almost any commodity.) Note that significant market moves only appear twice on this chart: during a period of about five days in the latter half of June and during a period of about five days in mid-October. Thus, the market was moving significantly on only about 10 of the 180 days shown in the chart. The rest of the time, the market was trading within a narrow price range.

To be successful, a trader needs to find these major moves and take advantage of them—or at least, not be on the opposite side when they occur.



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Figure 13-2. Six-day profile for December 1988 copper. The first five days' activity includes seven forms of buying (the points numbered 3, 4, 5, 7, 9, 10, 11) and only four forms of selling (the points numbered 1, 2, 6, and 8). Furthermore, note the shift toward buying during the last two days. This would lead us to expect the market to hold its higher level or continue up. (In fact, it traded in roughly the same range November 1, then moved up on the 2nd and 3rd.) Note that profiles are condensed. Assume the interpretations are correct.



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Figure 13-3. Bar chart showing six months' price activity in the Japanese yen market. Note the rarity of major price moves.

RESPONSIVE TRADES VS. INITIATING TRADES

Now let's look at the type of trade we intend to make. It may be a responsive trade, which calls for patience and good trade location and is usually a trade for tomorrow—a long-term trade. Or it may be an initiating trade, which calls for a commitment to act immediately. In the latter case, you will give up trade location to a degree because you expect an immediate response.

One of the major problems Market Profile students encounter in their trading is that most of their trades are responsive. Such trades are easier to put on, since the market gives you plenty of opportunities. The error lies in treating these as day trades, looking for an immediate response, which the market is not going to provide.

Traders also make the mistake of seeing the initiating trades shape up but then letting the opportunity go by before they act. Consequently, they do not have a high percentage of good situations on their trades, having let the best opportunities escape; instead, they end up with mediocre situations and false expectations.

To summarize this key distinction: you need to put on the initiating trade immediately, at the market. However, you generally have about an hour and a half to put on a responsive trade, given a fair price/value relationship. In this case, focus on patience and location rather than immediate gratification.

The next consideration is the time frame of your trade—whether it will be a day trade or a beyond-the-day trade. It's important to determine this ahead of time, while you are in an unemotional state. The key here is to avoid turning day trades into beyond-the-day trades just because they have been profitable; and to avoid turning long-term trades into day trades just because you have made an immediate

loss or profit. Formulate your plan before entering the trade, and stick to it.

Your orientation to the market should include all possibilities. If you feel that there's no way Event X can occur, that's exactly when it is likely to happen. And it's likely that everyone else felt the same as you; so when the unexpected takes place, everyone must react to it. The moral: be very cautious when you feel that you're 100 percent right about anything; what you've found is probably obvious not only to you, but to everyone else as well. You always trade best when you respect the market.

Putting the trade on means getting your idea to the market. The best kind of trade to make is the tough trade, which, paradoxically, can be both the hardest and the easiest trade to make. It is hard because you don't have a lot of Company when you make a tough trade, which makes it lonely. But when you are right, others will follow you, giving you a market to exit on. Thus, the tough trade makes your trading easier in the long run.

The area in which to make the tough trade is the first or third Standard deviation of the Steidlmayer distribution. These locations represent the beginnings and endings of distributions, which are desirable locations for putting your trade on. You should try to coincide with earlier reference points at the same time.

TRADE MONITORING AND EXITING

Once your position is in place, you need to monitor the trade. To do this, you must first determine your expectations for the trade. What would you like to have happen? What do you need to have happen to fulfill these expect-

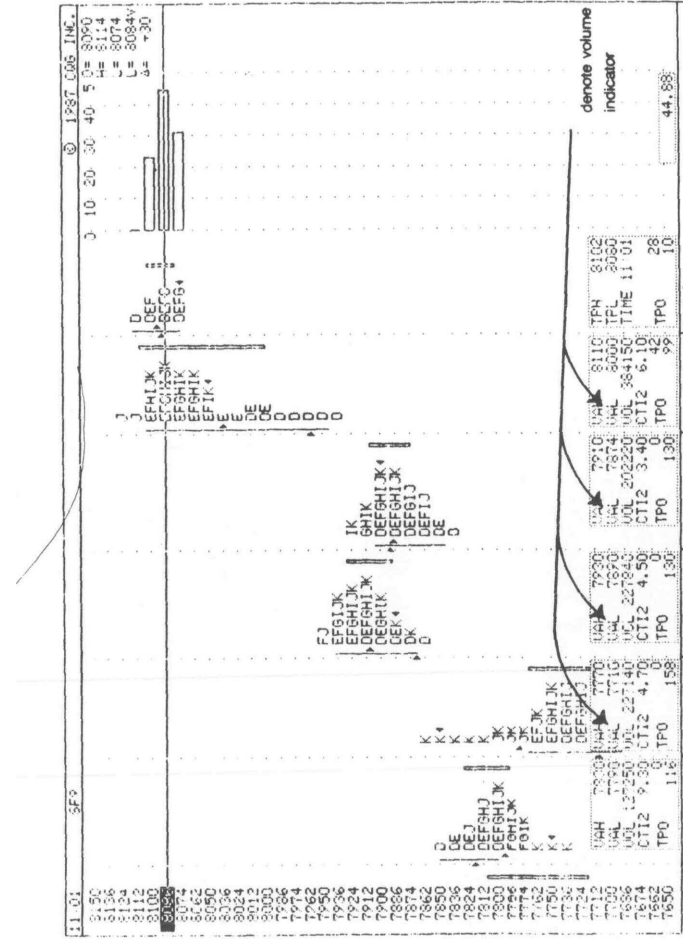
tations? If you get this, fme. If not, it needn't be disastrous, so long as what you do get isn't adverse.

As you monitor your trade, get as close to the market as possible by following emerging market activity, as we discussed earlier. Follow this up with reference to developing market activity. Determine whether your capital is safe or in jeopardy, with reference to the plan you developed during your trade preparation period. Once you're satisfied (usually half an hour to an hour after putting the trade on), check the reference points above and below the market, and look at the possibilities for multiple distributions. Your on-line volume numbers, if they are higher or lower than those for the previous days, will be helpful in tracking and describing market activity (see Figure 13-4).

Finally, you need to learn how to exit the trade. The most important lesson—one I can't emphasize enough—is not to overstay your position. If you have a tendency to overstay, it will be very difficult for you to be a successful trader. You need to become aware of your own pattern of behavior so that you can correct it if necessary.

Naturally, capital preservation is your first consideration; if you lose money, you have to make it back before you can even begin to profit. But you can't be too gimmicky about capital preservation. You can't swim without getting wet, and you can't trade without occasionally losing.

As your trade continues, ask whether you have reached your time frame. Once you have, exit. If not, hang tough, while remembering the importance of capital preservation. What if you miss the best opportunity to exit your trade? There is a strong human tendency, once the best opportunity has surfaced and has not been taken advantage of, to wait for the market to repeat that opportunity. However, if that opportunity really was the best, it will not



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Figure 13-4. Six-day profile for January 1989 soybeans. Notice the relationship between price and volume and what it tells us about the market activity. October 27 was a light volume day. On October 28, the market tried to break on high volume, but failed to do so; there were many responsive traders buying below the previous day's value. On November 1, the market tried to correct, but volume fell about 10 percent; so the market wanted to go higher. This was confirmed on November 2, when the market distributed higher seeking a fair price, on much greater volume. So we anticipate now that the market will hold this range or continue higher.

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reappear. If it does, the market will go on to give you an even better opportunity. So be psychologically disciplined enough to realize when the best opportunity has presented itself, and be prepared to accept something less than the ideal when deciding how to exit your trade.

TIME AND THE TRADER

The central concept of natural trading is finding a good idea that can be converted into an opportunity and placed in the market under advantageous conditions. It will then take a while for the advantageous conditions to unwind. During that time you'll be able to follow the trade monitoring and exiting processes as they relate to capital preservation and enhancement.

Time can be used twice here: first, to reflect on good ideas and to work hard at developing and updating your background information; and second, by using the unwinding of conditions or of a distribution, to give you time exposure in the market. If you do this, you'll be reacting to price positively rather than negatively—taking advantage of price and receiving a premium, rather than paying one.

Epilogue: The Future

In this book, you've experienced the growth and education of a trader. You've also seen the need for continued growth and learning as markets change and new opportunities arise. I think you've seen that sound, solid principles are the necessary base on which every trader needs to build. These principles can grow out of each experience in our life as well as from all that you do and observe in your professional endeavors. With these strong principles as your base, you can develop the patience and confidence you need to become a successful, independent trader. In this process, we hope you'll find the structure presented in this book to be beneficial and helpful.

I expect the world of the future to be a better place than today. Much of the improvement I foresee will be due to the growth and development of markets around the world. As the markets penetrate areas of poverty and inequity, both the economies of the world and the markets themselves will be strengthened.

Markets benefit civilization to the degree that they serve the people. As globalization expands the existing markets, attracting new participants and bringing more and more of the world's people into their orbit, the undeveloped regions of the globe will surely benefit.

I hope the work I have done will help to advance the process of improving the human environment and the world's Standard of living by helping to expand the under-

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standing of markets and the benefits they bring to all levels of society.

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