Topic No. 1: The Basics of Market Profile

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UNDERSTANDING THE MARKET

- Did you know that all prices are set through an auction process?
- Price is the tool used to advertise value
- Price auctions up to motivate sellers; it auctions down to motivate buyers
- When buyers and sellers find an acceptable price, they trade in large volume and “value” is created in that area
- This is simple but important to understand
- There are NEVER more buyers than sellers. Just more aggressive ones.
A QUICK OVERVIEW OF PROFILING

- Traditional Market Profile (MP):
  - Consists of TPOs in the form of letters that represent 30-minute increments of time but offset to the left and in the shape of a histogram.
  - Is not a trading system or methodology. MP is simply a way of organizing data.
  - Advantages: Makes it easy to see where the market has spent the most time.
  - Disadvantages: Does not give you any perception of “how much” traded anywhere. There are also many misconceptions about what it is telling the trader.
  - I do not believe in “value areas” in the traditional sense. This area has been misapplied in existing literature.
  - Much of the theory and application of MP revolves around the time brackets. After viewing it this way for years, I see a better approach.
A Traditional Market Profile
A QUICK OVERVIEW OF PROFILING

- The Volume Profiling (VP) Approach:
  - Simply displays Volume At Price data for any given time frame or duration
  - Organizes the volume information in the same way as MP does but is not restricted by time. Time is already represented in the bars overlaid on the VP
  - Advantages: Does not change the outcome of the profile even if the time frame is changed. The data is the same for all participants assuming that the tick data is accurate and not aggregated
  - Disadvantages: Requires a very high quality data feed from a reliable source. Your volume profile is not as useful if the volume is simply distributed over 1-minute bars
WHAT IS THE MARKET TRYING TO DO?

2 Modes to the Market:

- **Horizontal Development:**
  - Market is accepting a price area as mostly fair and is willing to continue to do business there

- **Vertical Development:**
  - Market is in price discovery mode and is trying to price in new information

- What do these look like?
  - I thought you would ask….
PARTS OF THE PROFILE

- **TPO** – Time Price Opportunity. A letter representing a set period of time (normally 30 minutes)
- **IB** – Initial Balance. The 1st hour of trading. Why is this important?
- **HVN** – High Volume Node
- **LVN** – Low Volume Node
- **POC** – Point of Control (VPOC for Volume POC)
- **Value Area** – This is the area that represents 70% (1 Standard Deviation) of all of the data in the profile. Is this important?
- **Composite Profile** – A Profile made up of 2 or more days to capture a bigger perspective on current action (seeing the forest from the hill)
Composite Volume Profile going back to swing low of November 2, 2009
TYPES OF PARTICIPANTS

- Other-Time Frame Participant:
  - How do we detect this participant?
  - Why does it matter?
  - Initiative Buyer/Seller vs. Responsive Buyer/Seller: What this means to our next trade...

- Compound Auction Market:
  - They come in all time-frames.
OPENING TYPES

- **Open Drive:**
  - If the market opens above or below prior day’s range or value area, then an Open Drive is dominated by responsive buying or selling back to prior accepted value. If the market moves away from the prior day’s range, then the open is dominated by initiative buying or selling. You want to detect this early and not trade against it. OTF is highly active and is accumulating/distributing aggressively.

- **Open Test Drive:**
  - Market opens, moves a short distance in one direction and then another trying to advertise for one side or the other to step in. This will usually test a prior key area and then push once it has gained conviction that nobody is left to oppose it. OTF waited for a test and has stepped in to execute in a fixed direction.

- **Open Rejection Reverse:**
  - Market attempts to continue in a prior direction and is met with fierce opposition and off to the races it goes. This is like an open drive, but it has gone to an area that did not meet with acceptance. OTF has found an area of conviction to participant in the opposite direction.

- **Open Auction In-Range:**
  - Scalper’s paradise. Nothing has changed between this session and last. Market will likely be unfriendly to breakout traders and will reward those who trade from the extremes in. OTF is not present.

- **Open Auction Out-of-Range:**
  - Market opens outside of the previously traded range. There is a high probability of OTF action and these can be BIG days. There will be a higher level of conviction by responsive as well as initiative buyers or sellers.
HOW DO I PROCESS THE PROFILE?

- What is my approach?
  - I make sure that I have complete **tick** data for the time frame that I am using
  - I break down the information into:
    - Overnight trading (O/N)
    - Regular Trading Hours (RTH)
    - Composite Profile of all data going back to the last swing high and low of interest
  - My hypothesis is based on a top-down approach of all 3 starting with the composite; which I display using daily bars but which still contains tick-volume data
  - Once I discover the bigger “areas to do business”, I drill down to the RTH sessions and look for detail that is reflected in the composites but also take into account prior close, current open, highs, lows, etc
  - I integrate into the RTH session the information provided by the O/N session. Specifically, I look for O/N Volume Point of Control (VPOC), highs, lows, etc. and note them on the RTH chart
What is my approach?

Once I have all of these pieces, I use these data points for major decision making and then watch for the market action as these areas are approached.

I have an expectation of what might happen. If the expectation is not met, then this is an additional, immediate and real-time data point that I use.

Once RTH trading is on its way, the current intraday VP becomes a dominating factor and I will continue to use that for ensuing trade decisions while keeping the composite in mind as a major guide.

I do not pay attention to “value areas” except under specific circumstances.
WHAT ARE MY CORE TRADING PRINCIPLES?

Here are my core directives:

1. I only trade during RTH and do not hold O/N positions
2. I am not interested in O/N structure or data once I have transposed it onto RTH. O/N data trades based on correlated spreads and does not have the 500 stocks trading for the ES at that time
3. I am a discretionary trader with rules that allow me to play anywhere in the field, but with the constraint that force me back in line if I’m trading what I want to see rather than what is
4. I trade based on auction market theory and my entire approach is based on the fact that the market is a simple auction process. I follow the story and can then create sound hypotheses of what to expect
5. Simplicity is king!
6. No lagging indicators or derivatives of price. I want to see the auction as purely as I can
7. Risk management, journaling, research and homework are the holy grail. My daily stop limits are set. My risk is accepted and mitigated through scaling and I press my trades that are supported by the market
THE PRINCIPLES OF TRADING SUCCESS

- Treat trading as a business because that is what it is. There is no minor league and it is no different than running a corporation.
- Keep track of your victories and defeats. Nothing will provide you with more feedback and protect you from self-deception than a good journal and chart log.
- Do not trade for $$ gains. Trade to execute your homework and plan. The $$ will come on their own. Keep your P&L out of sight.
- Don’t trust anyone else’s homework. Ultimately, it is your trade, your money, your time and your gain or loss. Trade and be proud of the fruit of your own labor, not someone else’s approach.
- Pay it forward. Attachment to money is the reason for the roller coaster that causes traders to lose.
This is your chance to:

- Ask questions
- Provide comments
- Decide if you want to learn more and continue your support