

SURFING THE ORDER LINES

By Daryl Guppy

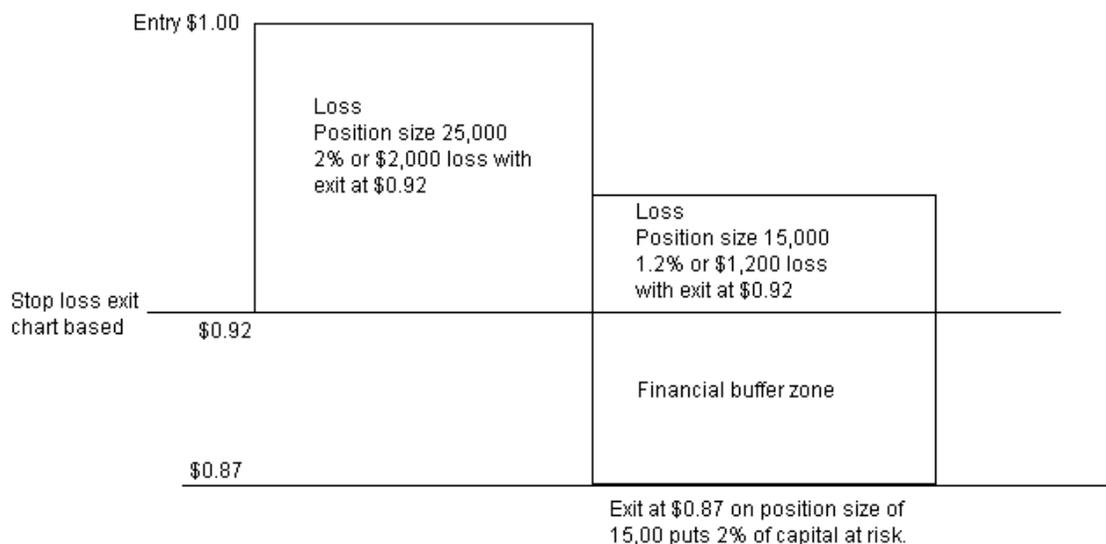
Most of the newsletter case study examples are end of day. The exit signal is based on the closing price and the exit decision is made on the next day. In the newsletter we often talk about stop loss exit discipline and the role this plays in long term trading success. It is a habit I stress in all my books, and this is common with most serious trading books.

But every now and then we override this rule and keep a position open after the exit signal has been given. This is a discretionary decision which is used in real trading. Several readers have asked for an explanation, and it is difficult to write about. This type of decision is based on experience and feel for the market. It relates to the behaviour of the market, and the behaviour of the particular stock being traded. There are many small details that come together to help form an overall picture that contributes to the decision to delay the immediate execution of a stop loss order when the market opens on the next day. For convenience, I have called these modifications. In these notes I have tried to bring together the way these decisions are reached.

This applies to a quite specific situation. The trade has been opened, but it is still in a technical stop loss situation. An exit at the stop loss level will give a capital loss on the trade. These notes only apply to existing trades that are profitable. The level of loss is the first important modification.

Modification 1 – An exit at the planned stop loss level has less than 1.5% risk of total trading capital.

If yesterday's close puts at risk 2% or more of total trading capital then the trade is closed at the open of trade on the following day. With a 2% loss there is no room for manoeuvre. A further price fall increases the level of loss beyond acceptable limits.



The impact on trading capital of a stop loss is reduced by reducing the position size. This means that a fall to the chart based stop loss level puts less than 2% of total trading capital at risk. The smaller position size creates a buffer zone. Price can fall below the chart based stop loss at \$0.92 and still not put at risk more than 2% of total trading capital. This buffer zone gives more flexibility in the stop loss exit execution.

Modification 2 – Volatility behaviour within the market or market segment shows low volume price dips followed by rapid rises

This is the general market conditions that have prevailed in early 2008. Sudden price drops on very low volume were common. Some of these occurred intraday, and price quickly rebound and closed much higher. This was created by small traders dumping a small quantity of stock in panic. If this 'dump' took place just on the close it triggers a stop loss signal, but the signal is not supported by the usual trading behaviour of the stock.

If this happens during the day traders can soon see that this was a 'false' signal. If it happens at the end of the day, traders must wait for trading the next day to see if this is a false signal. We look at these methods below.

This type of small trade is sometimes called 'printing the tape' or 'marking the tape.' It is a method used by market makers to 'gun the stops.' Anecdotal evidence suggests it was used by short sellers in recent markets to 'gun the margin stops.' The idea behind this market manipulation is to 'print the tape' at a price level with a small sale. The sale at this price may trigger some automatic stop loss sell orders in the market. This increases the selling pressure, and other sellers join in. The price falls in a cascade of sell orders. More particularly in the Australian market, it was claimed that some people were 'printing the tape' at levels where it was known were a margin call point.

This type of market manipulation is much more common in made markets, or quote driven markets such as the US and options markets than it is in order driven

markets such as Australia and Singapore. The book, *The Market Makers Edge* by J Lukeman goes into this activity in much more detail.

When the tape is 'printed' as the last trade for the day I want to reserve my judgement to see if this is just a single panic sale or the beginning of a larger sell off. This is where we apply tape reading skills.

TAPE READING

Tape reading is an old skill and the methods used by Jesse Livermore have been transferred to the electronic screen. Tape reading consists of several elements. It includes an analysis of the buy and sell order lines. It also includes an impression of the velocity of trading. Tape reading comes with an important caveat.

When we look at the order screen we see just a snapshot in time. It shows us only the activity of people who have placed a buy or sell order. It does not show us the activity or intentions of other participants who are also watching the screen and waiting to place a buy or sell order. We cannot know their intentions. The support we see at a price level based on a large buy order may disappear in an instant, letting the market fall. A support level that looks weak may be suddenly shored up with two large buy orders appearing within seconds of each other.

Other traders are watching the same screen that you are watching. You cannot second guess them, but the activity on the screen will give some guidance to how the order lines may develop. The velocity of trading gives guidance to buying and selling pressure.

VELOCITY OF TRADING

Velocity does not describe the speed of price change. It describes the speed of trading. The velocity of trading is the speed of the order flow. A sleepy stock is a stock A that may have 15 trades a day. A fast stock, stock B, may have 30 trades a minute. The velocity of trading is a relative term. For stock A, a period where there are 5 trades in a minute represents a massive increase in the velocity of trading. For stock B, an increase to 60 trades a minute is a substantial increase in velocity.

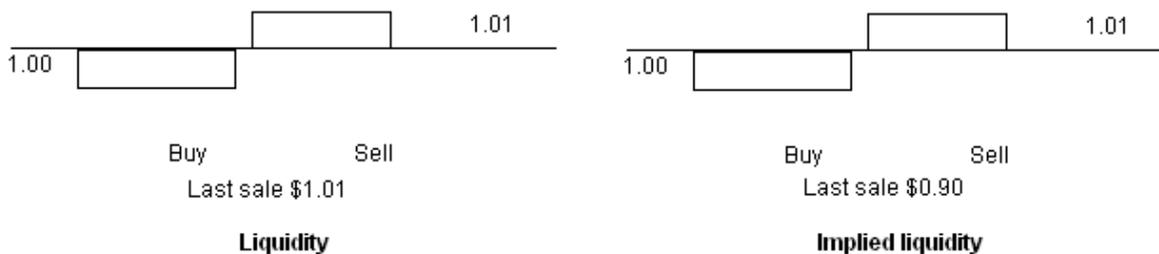
Increasing velocity where price moves in a single direction tells us there is a high probability of the price direction continuing. It may be a short lived surge in panic, or a sharp continuation of a pre-existing trend. This is easy to observe around known events, such as interest rate announcements. Bring up one of the banks and watch the speed to trading as the rate decision is announced. Prior to the announcement there is intermittent trading. You activity.

Most order screens highlight the last trade, and also any changes in price. After a rate announcement the trading order screen 'lights up like a Christmas tree'. This is an increase in the velocity of trading.

Tape reading is an art. I cannot provide any defined trading rules. Successful tape reading brings together an understanding of order line behaviour, a feeling for the way the market is developing, and a slightly different understanding and application of common beliefs about the relationship between volume and liquidity. The trading edge often comes from not accepting at face value some of the common beliefs about the market. There are three concepts for tape reading. They are liquidity, order line continuity and pressure.

LIQUIDITY

First, please put aside all your ideas about liquidity. They are mostly gained from discussion by the big fund managers who can only operate in a market where an order for 500,000 BHP shares can be easily absorbed by the market. This is not the area we operate in. Liquidity is related to the ease at which you can execute your order at its planned size. If I have 10,000 TLS to sell, the TLS has more than enough liquidity. I have 10,000 shares to sell in GCR, then it may take several separate sales spread over an hour or several days before this position can be 'unwound.' For most traders, liquidity falls somewhere between these extremes. Liquidity describes the ease at which we can unwind or sell our position.



Liquidity may be shown by constant trading activity. This is our most common understanding of liquidity. At any time we can enter the market and execute a trade at the market price because there is an active buyer or seller at or near this level.

Liquidity does not depend on depth. The depth of the market is the number of orders at different price levels. A deep market will have buy orders at \$0.95, \$0.96, \$0.97, \$0.98, \$0.99, \$1.00 and sell orders at \$1.01, \$1.02, \$1.03, \$1.04, \$1.05 etc. A shallow market will have a buy order at \$0.95, then at \$1.00, and a sell order at \$1.01, \$1.03, \$1.07.

Liquidity is the ability to buy or sell at your preferred price. The diagram illustrates the situation (In all these diagrams, the length of each box shows the volume relationship of orders.) There is a strong buying support at \$1.00. There is consistent selling at \$1.01. As a seller, if I chose to sell my shares at \$1.00 then there are enough buyers at this level to absorb all my selling. I chose not to sell at this level, and my sell order sits, for example, as second in line at \$1.01. The trading activity of the day shows zero turnover. In traditional terms, this is a low liquidity stock. In real terms it is not. Each buy and sell level shows sufficient depth to provide good liquidity should a trader decide to adjust their buy or sell price.

We also need to consider implied liquidity. This is implied liquidity and it is seen in the order line structure. This implied liquidity is an important feature in making the stop loss exit decision. Liquidity is also shown in a market that refuses to trade at a lower level even though the tape has been printed at that level. I call this implied liquidity.

Next week in part 2 of this article we look at how these features are combined to assess buying and selling pressure.