

# **TRADING FREE FLOAT VOLUME**

By Daryl Guppy

A few weeks ago a reader asked how to use the volume float analysis tools in Guppy Traders Essentials. I went looking for the original articles we did on this indicator and couldn't find them. This has forced us to revisit these neglected indicators.

## **THE FREE FLOAT THEORY**

The ideas of a free float is not well known but it's a vital underpinning in many aspects of fund management. Only stocks with an adequate free float are eligible to be included in the Morgan Stanley MSCI index. The MSCI indexes are the benchmark used by fund managers. If the stock is not included in the index, then the stock is not followed by the fund managers.

For many years Telstra was not included in MSCI indexes. The reason goes to the core of the free float theory. It goes like this:

Company A has 2 million shares on issue. Of those 2 million there are 500,000 held by long term investors, fund managers etc. These 500,000 shares are not available for trading. Company A has a free float of 1,500,000 shares that can be actively traded.

Company B has 2 million shares on issue. Of those 2 million there are 1,500,000 held by long term investors, fund managers etc. These 1,500,000 shares are not available for trading. Company B has a free float of 500,000 shares that can be actively traded.

Company A has a larger free float and would be included in the index. Company B would be excluded from the index because the size of its free float shares is too small. This is why Telstra was excluded when it was partially floated by Government. The free float was too small.

The next part of the theory draws on work done by Arp and others. It suggests that with Company A that when 1,500,000 shares have been traded that the entire free float has changed hands. This will lead to a change in the trend direction as the new stock owners have different expectations about the future of the price for the stock.

Retail investors barely know of this theoretical approach, but it is closely monitored and analysed by the large fund managers. They expend a lot of time and effort to estimate the size of the free float for each company. It's secretive and proprietary information.

In developing this suite of indicators we turned the idea on its head to see if we could establish a relationship between trend changes and volume turnover. We would then test this volume figure against past and future trend change points. If it was accurate, then we could use volume turnover to help identify trend change points.

## **FREE FLOAT IN ACTION**

Here's how it works. We start with a chart that has clear trend changes. The chart extract shows three clear trends A B and C.



The first step is to identify the volume traded in each of these trends. For these we use the FIND TREND VOLUME (FTV) tool in GTE charting. Select the tool and start at the low on trend A. Drag the line to the high of trend A and release. The volume turnover is 9,926,757 – around 10 million shares.

Do the same for trend B. The volume is 15,411,511 – around 15 million shares. For trend C the turnover is 10,413,105 – around 10 million shares. Other trends are 13 and 12 million.

Based on this behaviour we can conclude that when 10 to 11 million shares is the size of the free float for this stock. We can further suggest that when 10-11 million shares have changed hands that there is a high probability of a trend change. If there is also near to a move above a trend line then there is a very high probability of a trend change.

Using this inferred method to establish the size of the free float is much easier, and we find more reliable, than the free float calculations used by the index houses. And in any case, their calculations resulting from close examination of share registries are usually kept secret.

## TESTING TREND VOLUME

Now we have the figure for the approximate size of the free float we can PLOT TREND VOLUME (PTV) on the chart. Select an historical starting point for a clear trend change. In the dialog box enter the approximate size of the free float. We start 10,500,000 and the lines of the chart adjust automatically.



The 10,500,000 value doesn't give a good match, but if we change the value to 12,000,000 then this captures many of the historical trend changes very accurately. It's not a perfect tool, but this gives a good working estimate of the free float value for the stock. When 12,000,000 shares change hands AND there is a violation of a trend line, THEN there is a high probability of a trend change.

## PROJECTING TREND CHANGES

How long will the new trend continue? It will continue until around 12,000,000 shares have traded. Then we can start looking for other trend change indications. For this we use the CALCULATE TREND VOLUME (CTV) tool. Take the current chart. Select the bottom or top, of the most recent trend. The CTV tool will display the amount of traded volume between your start point and the last candle on the chart.



In this example 7,037,932 – seven million shares have traded so the trend is a little over half completed. If we are trading this trend then as the turnover volume approach the free float number of around 12 million then we would prepare to exit. If we were thinking of joining this trend then we know that when another 5 million shares trade then its time to think about getting out. This is a particularly useful volume analysis tool to apply to large cap and mid-cap stocks because it tracks the turnover of the available trading stock. It's not compatible with all stocks, but with some its remarkably accurate. The base stock for this example was ASX. We selected it at random simply because it had clear historical trending behaviour. The best candidates for this style of analysis are stocks with a history of clear trending behaviour and clear trend breaks.