

TRADING WITH EQUIVOLUME

By
RICHARD W. ARMS, JR.

www.ArmsInsider.com

Table of Contents

| | |
|-----------------------------------|----|
| Introduction | 3 |
| Technical Analysis..... | 7 |
| Equivolume Charting..... | 9 |
| Turning Points | 14 |
| Buying the Breakouts | 19 |
| Buying Continuation Patterns..... | 22 |
| When to Sell | 26 |
| Selling Short | 29 |
| Support and Resistance | 32 |
| Trendlines and Channels..... | 35 |
| Gaps..... | 37 |
| Conclusions..... | 39 |

INTRODUCTION

YES!

I just sold a stock for \$23 that I bought last week for \$18. What a high! That is the pleasure of being a trader, being right. Taking a profit is great, but the money is not as important as the success. I think the best trader is the one who only uses the money to keep score. He treats trading as a challenge.

In the pages that follow we are going to be looking at some unique methods of analysis that can help to make trading more successful and therefore more fun. When I say traders I am thinking primarily of those who buy individual stocks and hold them for a period of days, or at most a few weeks. All the examples we look at will be concerned with that time frame. That is not to say the methodology is not applicable to other time frames, it is. But our emphasis will be on short term trading. If we can think of the market movements as consisting of tides, waves and ripples, we are going to be looking at the waves. Day traders may want to apply the ideas to the ripples. Long-term investors can look at the larger picture and use the methods to take advantage of the large tidal movements. In addition, we will not be looking at options trading, just the underlying stocks. But anyone wanting to trade options must be able to understand where the underlying stock appears to be headed. Every principle in the pages that follow is a tool for the options trader as well.

When I first became a retail stockbroker, forty years ago, one of the first admonitions from the firm was that we were never to equate investing in stock with gambling. Even when a client was trading on a short-term basis, it was a no-no to suggest that it was a form of wagering. We were well above acting as though we were operating a Las Vegas casino. Moreover, it was pointed out, when you put your money on a roulette table or a horse, it either won and made money or it lost and you lost *all* your money. With stocks, there was residual value. You might sell at a lower price than where you bought, but you would get back some of your money. Therefore, it was investing, not gambling. Of course, if you were in a margin account, it might take a lot of it in a hurry. And if you did not act quickly enough and the market acted unusually, you could get wiped out just about as quickly as at a blackjack table. On the other hand, the right stock in the right market was not very different than the right horse in the Kentucky Derby. But still, it was not to be thought of as gambling.

In the pages that follow we are going to put that admonition aside, and realize that our only aim in the market is to buy at a lower price than we sell. The desire is to make money. The vehicle we will use in trying to make money is stock. Any stock that goes up when we are long, or down when we are short, is a good stock. I often say, when I am making a speech, that it would be a lot better if stocks did not have names, just numbers. Then we would not become emotionally attached to them. If it was just stock 175 instead of Compaq Computer, we would be less likely to make bad decisions because we “liked” the company. It is that sort of detached objectivity that we will be striving for in the pages that follow. True, it is not gambling, in that you are buying something of value; ownership in a corporation. But if one is adopting a short-term and aggressive attitude, that objective is far overshadowed by the fact that it is only a vehicle used to try to make money. Moreover, we are going to want to be as willing to sell short as we are to buy. Selling short is certainly not designed to participate in “Corporate America”.

Understand, we are not talking about the building of a long-term portfolio of stocks. That is an entirely different approach, and has been the basis of several of my earlier books. We are, in the pages that follow, going to be talking about the aggressive buying and selling of stocks. We are going to look at the short side as well as the long side of the market. We are not going to be talking about “owning a piece of Corporate America”, we are going to be talking about buying and selling stocks because we think the price is going to change in our favor.

But there is another factor that makes it far different than a trip to Vegas. When we pull the lever on a slot machine or place a bet on red at the roulette wheel the result is entirely a function of chance. We have absolutely no control over the outcome. Intelligence plays no part beyond that point. Perhaps we can know the odds well enough to place our bets where we have the best chance of winning, but we cannot play any part in where the ball drops in the slot or how the wheels turn in the machine. In the stock market we can be rewarded for being smart. We can make good decisions and swing the odds in our favor.

In addition, at the casino the house always wins. The odds are such that in the long run the gamblers are always the losers. It is not even a zero-sum situation. It is an automatic losing position, on average. In the market, if stocks are in a long-term advance, the buyers can all be winners, on average. In bear markets all the short sellers can be winners. Of course, there is still a cost of buying and selling, which puts a part of every

investment in the pocket of a broker. But it is not the handicap it once was. Commissions are now so low as to be of little concern. In a sideways market it is not quite a zero-sum game, but it is close to it.

As we go along we will be looking at a methodology that is designed to swing the odds in our favor. We will be combining price and volume into usable information. It is a methodology that helps to shield us from irrational emotional decisions. We will be concerned with the emotionalism of others, and attempting to recognize times when a swing in emotions is presenting an opportunity to make money. The interplay of price and volume will help to tell us what others are doing, and allow us to take advantage of that knowledge.

Interestingly, all of the methodology we will consider in the pages that follow have their place in conservative long-term investing also. In fact, my prior books have concentrated on that aspect of the market. We are going to be talking about the delicate balance between fear and greed that moves prices, and those forces are in control on the long term as well as the short term. For the purposes of this write-up our time frame will be days and weeks, but the same methods are effective as we move up or down the time scale. An Equivolume chart that is posted minute by minute during a trading day contains all the same characteristics as a chart posted on a daily or a weekly basis. We will be studying moves that develop over a few days, because that is also the focus of my website, ArmsInsider.com, which offers stock recommendations and is an adjunct to this book. A trader who wants to follow and use our recommendations needs to be familiar with the reasoning that leads to those suggestions.

We are living in a wonderful era for investors. Technology has made it possible, as never before, for a diligent trader to be successful. With the speed of computers and of communications, everyone has an opportunity to participate on equal footing. When I first invented the Arms Index (some people still call it TRIN) in 1967, I had to calculate it on a slide rule. Now it is calculated for me second by second and appears on almost every quotation device. It crosses the tape every few minutes on CNBC. When I first developed Equivolume charting, every chart had to be drawn by hand. Now there are computer programs that do it all, and do it well. I am able to follow thousands of stocks on a daily basis, searching for opportunities. Thirty years ago I hand-drew charts of a few dozen stocks, and when they went off the top or bottom of the page I had to start over. When the volume characteristics changed I had to rescale them and throw the old charts away. Today the computer recalculates and rescales the charts so

they always fit the page. Facts, rumors, advice and opinions flash across the screen on the Internet. Geography has become meaningless to the trader. Moreover, the intense competition of the marketplace has brought commission rates down so low that they are close to negligible. The trader no longer needs to be concerned with the transaction costs. If a stock is not acting right it can be sold and replaced instantly and almost without cost. What used to take a number of phone calls to a broker, wires to New York, calls back with confirmations and waiting days for balances, are all now activated by the click of a mouse button. The trading mechanics have become so efficient that no one need be disadvantaged because of geography or cost.

Now, with decimalization, spreads have contracted even further. There are now 100 possible steps in single point of range, instead of just eight a few years ago.

All this is good, in that the small trader is on an even footing with the big trader. It is also a curse, though. There is so much information, and so many rumors, and so many opinions, that it can lead to confusion and indecision. Modern communications have led to an overload of data. We will, in the pages that follow, try to cut through that morass, and concentrate on the few factors that can lead to extraordinary profits.

TECHNICAL ANALYSIS

This book is about technical analysis. Moreover, it is about one particular type of technical analysis. You will not see anything about earnings, or dividends or cash flows. Nowhere will we mention management or products or competition or sales. Search all you want but you won't find another mention of price to earnings ratios. All we are going to be concerned with is price and volume. We are going to look at the past, and try to anticipate the future, and we are going to do so without ever looking at a single fundamental factor.

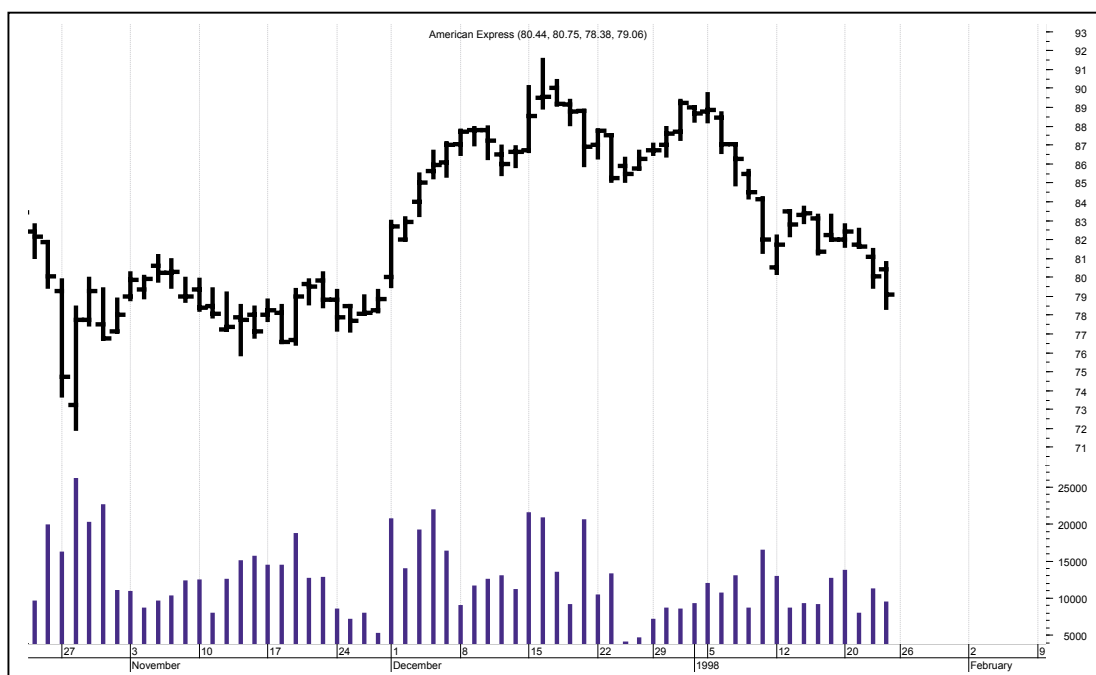
This is not because of laziness; it is because of our need to be realistic and objective. The stock market determines the price of a stock, and the volume of the trading represents the amount of interest in that determination. That determination is based upon all the factors mentioned above; the fundamental factors I will not repeat because I said you would not ever see them again in this book. But the fundamentals do not directly determine price. First they have to be passed through a very critical filter, which is the emotionalism of the marketplace. The fundamentals are only as important or unimportant as the emphasis placed on them by the millions of minds studying them. We have all seen a stock go down on a good piece of news or up on news that looks terrible, and we have shaken our heads in disbelief. That was because we were trying to predict what other people would think of that news. But the market is never wrong. It is reflecting exactly what the consensus really is. The market is a very efficient and accurate reflection of the facts, but only after they have been analyzed and then reacted to in an emotional manner. In the final analysis, the price of a stock and its volume are a reflection of a delicate balance between fear and greed. That balance is influenced by the underlying fundamentals, but is not a direct representation of those fundamentals.

In using technical analysis we are deciding to study the output of those emotional responses, rather than try to second-guess what they may be, based on our limited knowledge of the "facts". When we look at price and volume, we are looking at all the facts; they have been interpreted for us, and translated into fear or greed. It is not laziness that keeps a technician from looking at the fundamental data, is the knowledge that everything that is known about a stock has been already taken into account, and it is publicly available in the form of the price of the stock and the amount of stock that is changing hands.

The way in which the methods that follow are different than other technical analysis methods is the great dependence upon, and emphasis of, **volume**. It is, I believe, of paramount importance, yet it is often ignored. Many traders do not even follow the number of shares being traded, relying wholly upon price movement to make their decisions. Yet, without knowing the volume one has no idea of how much conviction is involved in a move. It is like buying a car without looking under the hood. One needs to know if that car has enough power to get over the hills. It can have a beautiful paint job, wonderful upholstery, great tires, but it is useless if it doesn't have an adequate motor. Volume is the motor of the marketplace. We are going to be looking under the hood of each stock we trade, and seeing whether the power is there or not. To do that we are going to use my unique charting method called **Equivolume**.

EQUIVOLUME CHARTING

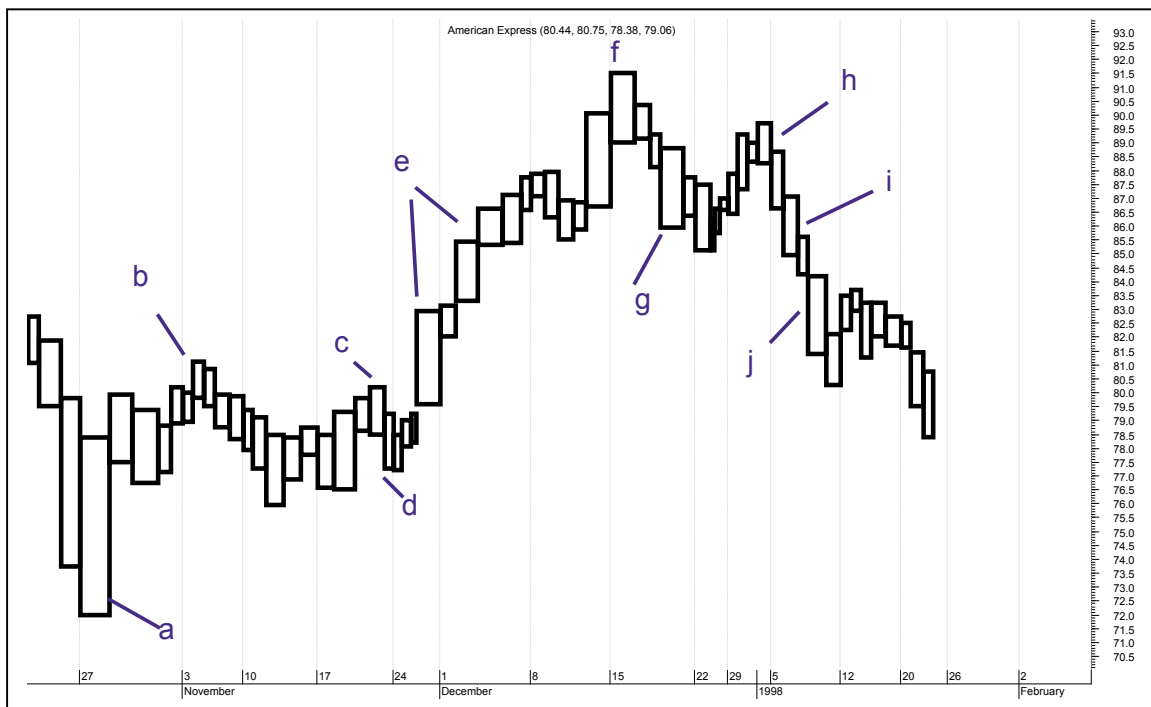
Shown below is the type of chart we are all familiar with; a bar chart. In this case each vertical line represents one day of trading. The top of the line represents the high of the day and the bottom of the line represents the low of the day. The little horizontal line is the level at which the stock closed on that day.



Across the bottom of the chart is a histogram that represents the volume. By tracing upward we can equate the volume for each day with the price action on the same day, but it is difficult to know precisely which volume applies to which price in every case.

When I first thought of Equivolume as an alternative to bar charts I had already become aware of the importance of volume. I knew that it was necessary to see whether volume was heavy or light as a stock moved through an old level of resistance or support. I knew that volume tended to become heavy, and price spread tended to shrink, at important tops. I had become aware that large price swings on heavy volume were typical of climactic bottoms. I was intensely aware of volume, because it was volume that was at the foundation of my, by then already popular, Arms Index. It bothered me that volume tended to be relegated to a secondary significance, or even completely ignored at times. I felt that volume needed to be made a full partner with price if one was to understand the underlying dynamics of price movement.

When it came to me, driving home one afternoon, it was absurdly simple. All that was necessary was to combine the two pieces of information into a single posting. I would move volume off the lower margin of the chart and incorporate it in the price posting. Each day would appear as a rectangle, with the width being the volume. The top of the box, as with a bar chart, would be the high of the day, and the bottom of the box would be the low of the day. All I would be doing would be spreading each bar chart line sideways into a rectangle, as a function of the number of shares traded. The results were fantastic! Each posting started to give a much more complete picture of the trading. I found that each box was giving a concise picture of supply and demand for that stock on that day. Shown below is an Equivolume chart of the same stock over the same period we were looking at above.



The first thing that becomes immediately apparent on this chart is that all days are not the same. Compare the box marked “a” with the box market “b”. Each represents a single day of trading but one is tall and wide while the other is short and narrow. Obviously, “a” was a very significant day. There was a wide trading range and heavy volume. Box “b” was a far less meaningful day. Volume was light and there was not much price movement. Box “h” was short but fairly wide, indicating volume but lack of price movement. It was suggesting the stock was encountering resistance after the light volume rally. Box “i” was tall, but on good volume, and was saying that the stock

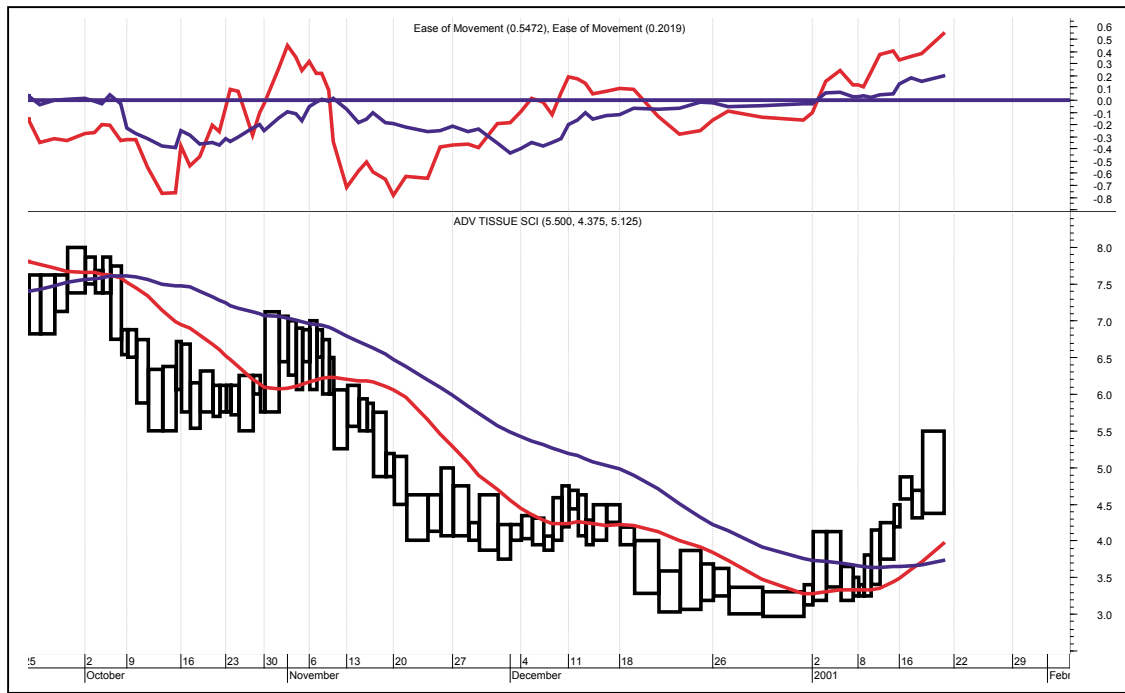
was moving downward with vigor. The shape and size of each box has a story to tell. Let us go through all the indicated boxes on this chart, and see what they were telling us.

- a. A heavy volume reversal day. This looked like the culmination of the decline. Heavy volume and a wide spread are typical of the final washout of a drop.
- b. A light volume rally off the low. The lack of volume makes it far from convincing.
- c. Here we are seeing a rally with better volume. It suggests that the low was tested, and that the rally might carry further.
- d. Notice the very light volume on this pullback. It now looks as though volume is coming in on the upside and drying up on the downside. That is a very bullish sign.
- e. On the next day volume explodes to the upside, penetrating the resistance we saw at "b" and saying the stock is headed higher.
- f. After a big advance over the prior two weeks volume remains heavy but the range contracts. Perhaps the stock is encountering resistance after such a sudden rise.
- g. This is ominous. Heavy volume to the downside and a wide trading range. If we were to insert a trendline along the bottoms of the rise, this drop would penetrate it. But the narrowness of the top suggests it is not likely to go lower until some attempt to rally is made.
- h. The stock rallies, but the move lacks volume. It looks like a lighter volume test of the heavy volume top at "f".
- i. The decline resumes, on heavier volume, and support is penetrated decisively.
- j. The decline continues.

This is a fairly typical Equivolume chart, posted on a daily basis. By going to weekly postings or three-day postings a longer-term outlook can be achieved. Very aggressive intraday traders might go to hourly charts or even five-minute charts. On our website, all of the Equivolume charts are daily, with the aim of taking advantage of price moves lasting a few days or, at most, weeks. But in any time frame, the signals given by the price to volume relationship are similar. On longer-term charts they tend to be more muted and on very short-term postings they tend to be more erratic. But the rules are the same. The shape of each box and its size tells us how easy or hard it is for price to move in a given direction.

There are other tools that are used as well. The chart below has the appearance of the typical chart published on our website. On it you will see a number of other lines that need some explanation. But first look at the boxes on this stock, as we did on the prior

example. Notice particularly the two boxes at the low. They are very wide and short. They denote extremely heavy volume in a narrow trading range, and indicate a strong level of support.



Followed by the two up boxes that are tall for their width, but still are on fairly heavy volume, we have a signal the stock is turning up, and it is time to buy. Notice also the last posting on the chart. The stock has moved through an old area of resistance with increasing volume and a widening range. That is a very bullish signal. As we will see a little later, a light volume pullback is likely before going higher. Often we will look for that pullback before buying.

Superimposed on the Equivolume postings are two lines, one red and the other blue. They are moving average lines, but not the usual moving average lines of Wall Street. Instead of being based on time they are based on volume. That is, heavier volume days contribute more to the moving average than do light volume days. A complete discussion of Volume Adjusted moving averages is beyond the scope of this presentation. I would suggest anyone interested in the derivation of these lines read my book entitled "Trading Without Fear". For the purposes of understanding the information on the charts, notice that the two lines tend to cross at or near important buy and sell points. Because they are volume adjusted they tend to be more sensitive to the heavy volume of tops and bottoms, and give earlier signals than do the usual time-based moving averages. The hand calculation of these lines is an immense job, but with today's computers

and sophisticated programs, we can easily use them without worrying too much about how they are derived.

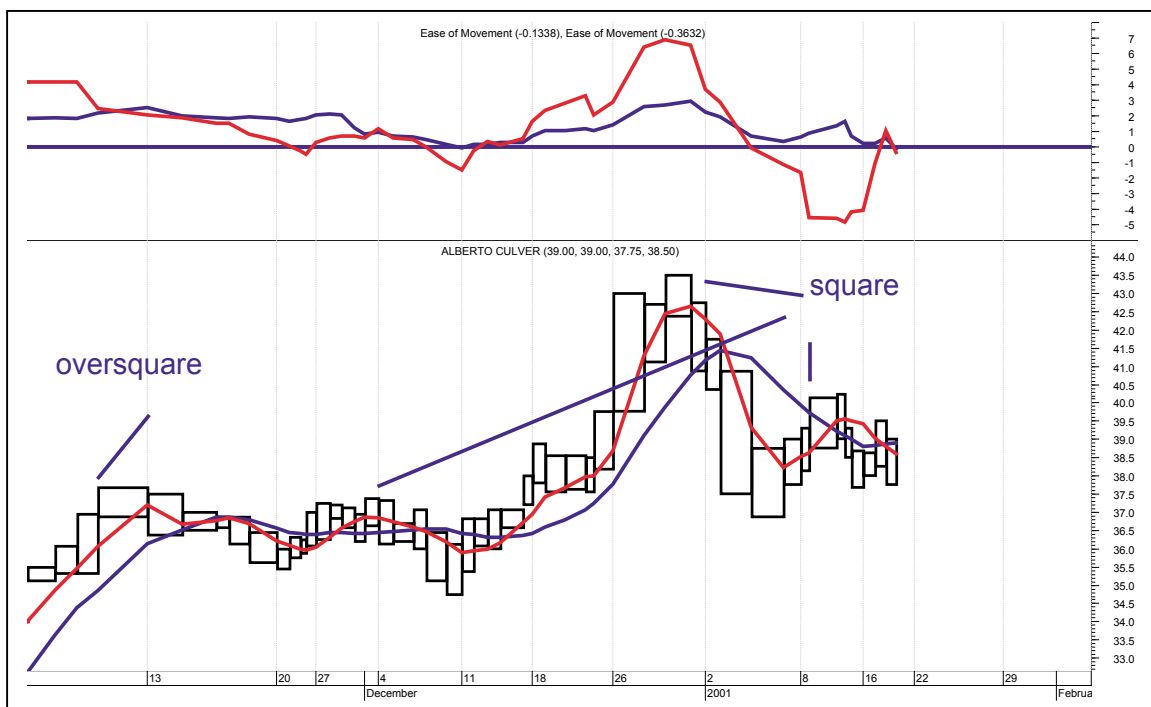
Across the top of the chart are seen another pair of lines. They too involve a difficult set of calculations, but are nothing to a computer. They represent two values for the Ease of Movement. Ease of Movement is a method of valuing each of the Equivolume boxes numerically, taking into consideration the size and shape of each box and the direction and extent of the daily price change. It is an attempt to ascertain whether it is easier for the stock to move up or down at any given time. As with the Volume Adjusted moving averages, we look at the crossover of the two lines as a clue to future price direction. A complete discussion of Ease of Movement is available in my book entitled "Volume Cycles in the Stock Market". These, and my book entitled "The Arms Index", are available for purchase at our website bookstore, or through most book dealers.

Obviously, these charts represent a sophisticated set of computer programs. In the early days I drew charts by hand, and did the complex calculations of Ease of Movement and Volume Adjusted moving averages with a hand calculator. Today there is no need for that. All the charts in this book were produced using the Metastock program marketed by Equis International. (<http://www.equis.com/metastock/windows95nt/>) Tell them you are interested as a result of talking to Dick Arms and you get a discount. As an ArmsInsider subscriber, you may want to have this program in order to follow up on suggestions after the original recommendation has been made.

TURNING POINTS

Tops and bottoms are not for buying or selling, they are for covering long or short positions. A possible top is an unconfirmed move, and trying to short a stock on that basis is too risky. But it is a time to take a profit. Similarly, something that looks like a bottom is a good time to get out of a short position, but the risks are far too high to use it as a buy point. We will look first at Equivolume signals that suggest tops and bottoms because they are the most obvious boxes on an Equivolume chart, usually. Later we will look at the signals that are going to be our buying or shorting points.

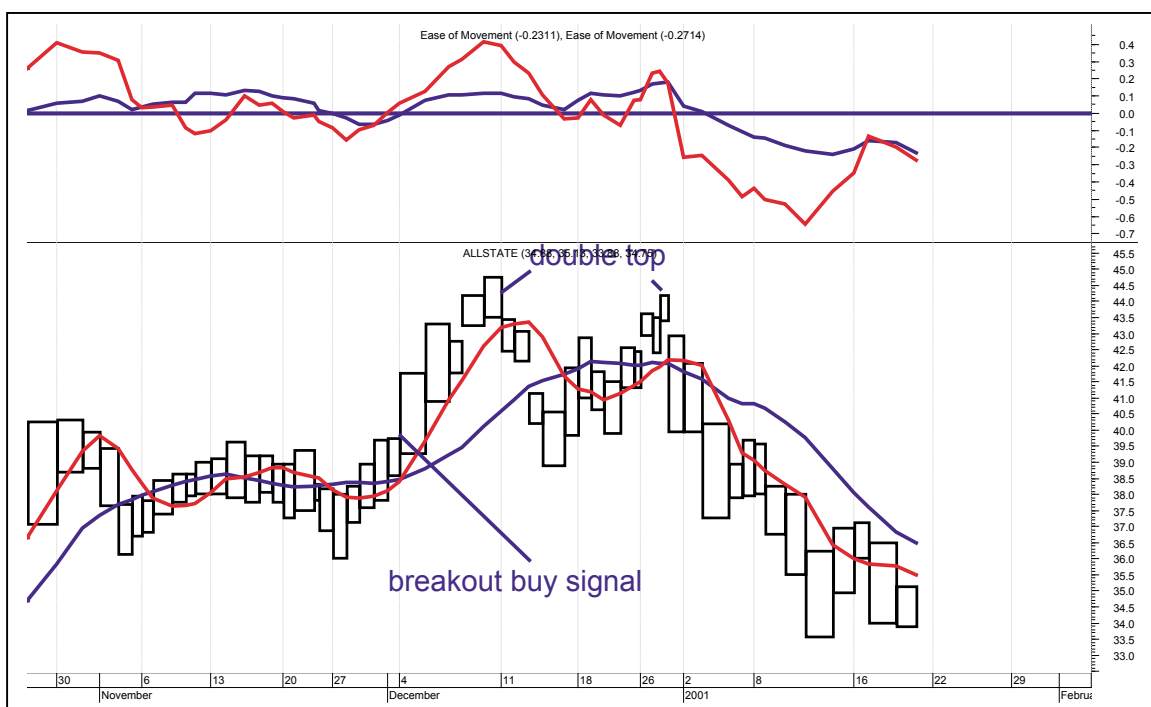
When a stock gets to a top, it usually tells us so. Volume becomes heavy, and the price refuses to move. That produces an Equivolume box, or a series of Equivolume boxes, that are very wide for their height. You will often see them referred to as “oversquare” boxes.



On the chart above we see a number of instances in which the trading range became very tight while the volume became heavy. That produced the square and oversquare boxes. The reason for this happening is simple. After an advance, there are still buyers trying to push the price higher. But they are encountering well-entrenched sellers who are willing to give them all the stock they want at a given price. As the buyers push upward and the sellers resist, heavy volume is created, but the price acts as though it has encountered a brick wall. It is usually a clear sign of a top, and a warning that

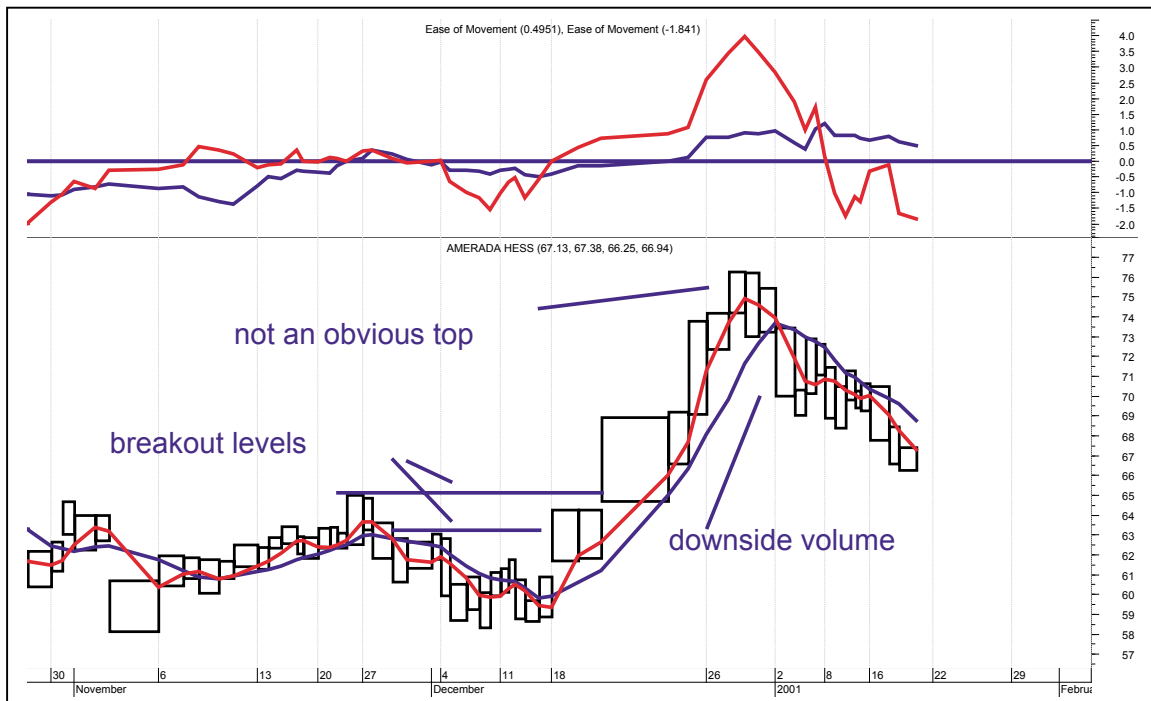
prices are likely to head lower. In trading stocks we will usually believe such a sign, and be willing to take the profit. Obviously, there are exceptions, but it holds true often enough for us to heed the warning.

Often a stock will make a double or a triple top before heading lower. For a longer-term investor that is a signal to get out, but as traders, we are not likely to wait that long. Typically a triple top shows up as a big square entry on the first top, and then diminishing volume on the subsequent tests of that top. A trader is well advised to get out on the first big square, and take the profit. If it goes higher later, instead of forming a double or triple top, who cares.



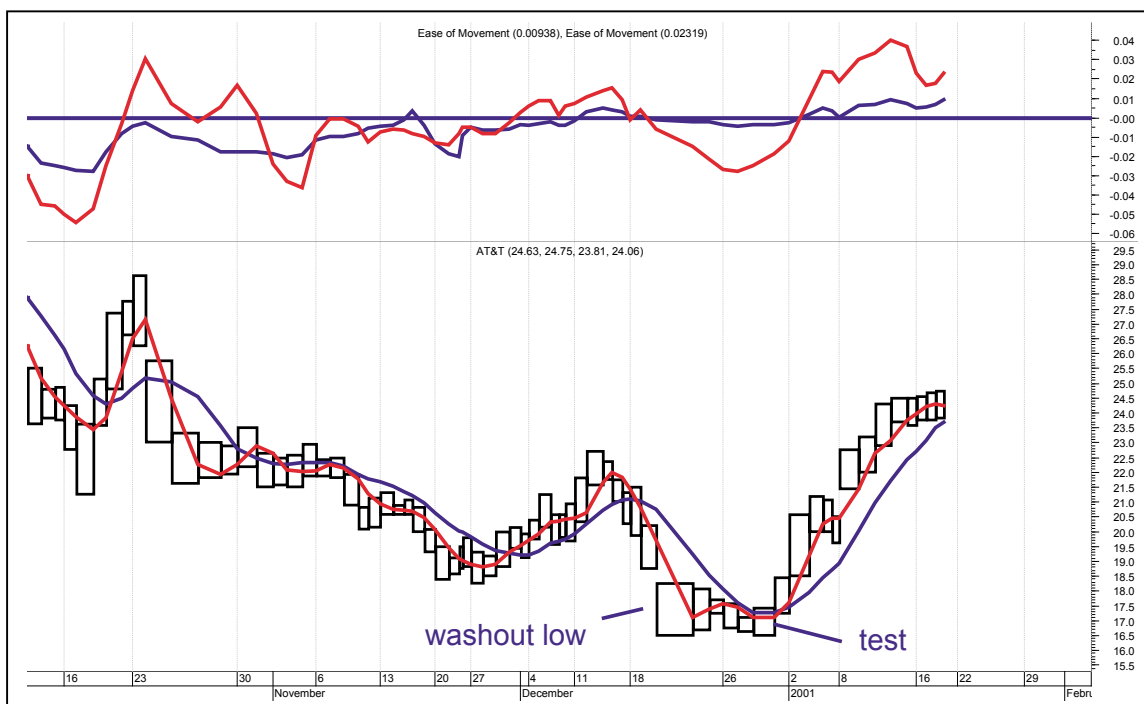
On the chart above, we might have been buyers when the stock broke out above resistance. Just a few days later, at much higher prices, we started to see signs of resistance. That was the time to take the profit. Later it did go back up to that level, and formed a wide double top. That then led to a very big decline. But, as traders, we would not have waited around for all of that. The stock told us very early that it was running into resistance and should be sold.

Unfortunately they do not always act exactly as we expect. Sometimes the topping action will be far less obvious.



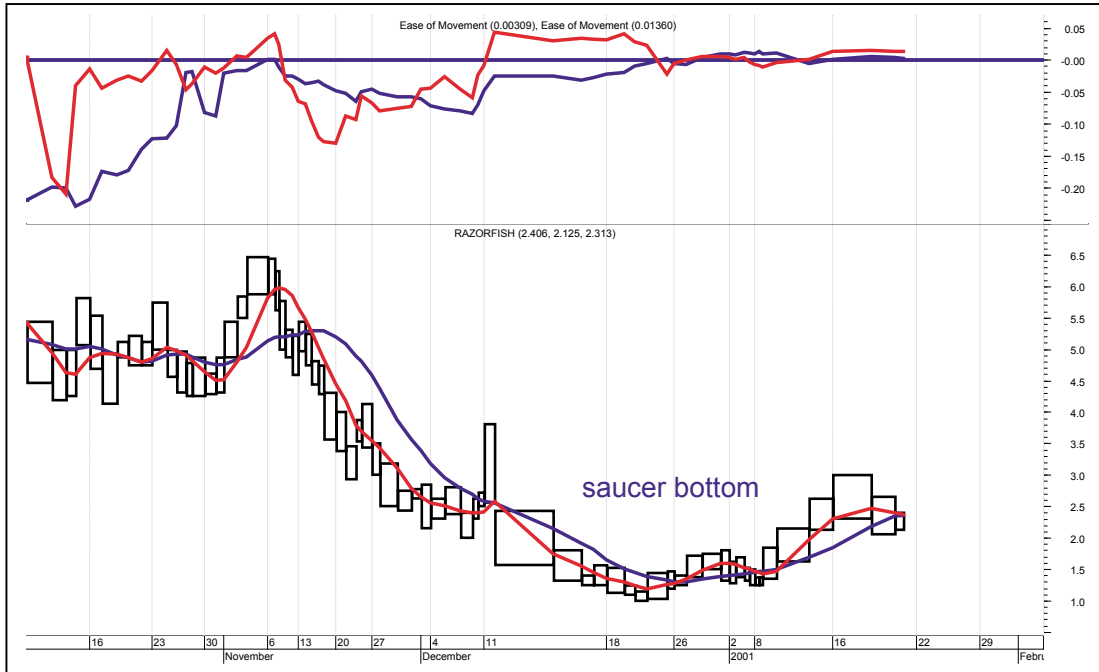
The breakout was obvious in the stock above, and the subsequent move was very gratifying. But, when it reached the top it did not tell us so. The range did contract, but the volume was not excessive. Only a couple of days later did it become apparent that there was trouble. The clue was the heavy downside volume with a wide trading range. The ascending trend was broken, and it looked as though the stock was headed lower. On tops that are not typical, we need to watch for other clues.

Lows tend to be different than highs. They are more emotional. Fearful selling often results in climactic action, in which volume becomes very heavy and the trading range, unlike a top, is wide. Therefore we are more likely to see very large Equivolume boxes on bottoms, but they are less likely to be square or oversquare. The typical bottom consists of a big box that washes out the sellers, followed by an immediate rally, and then a lighter volume pullback that tests the old support.



On the above chart we see that the stock had been in a long decline. Finally it gapped down on huge volume and seemed to get rid of the last of the sellers. That was followed by a weak rally, then a return to the low, before a believable rally could get under way.

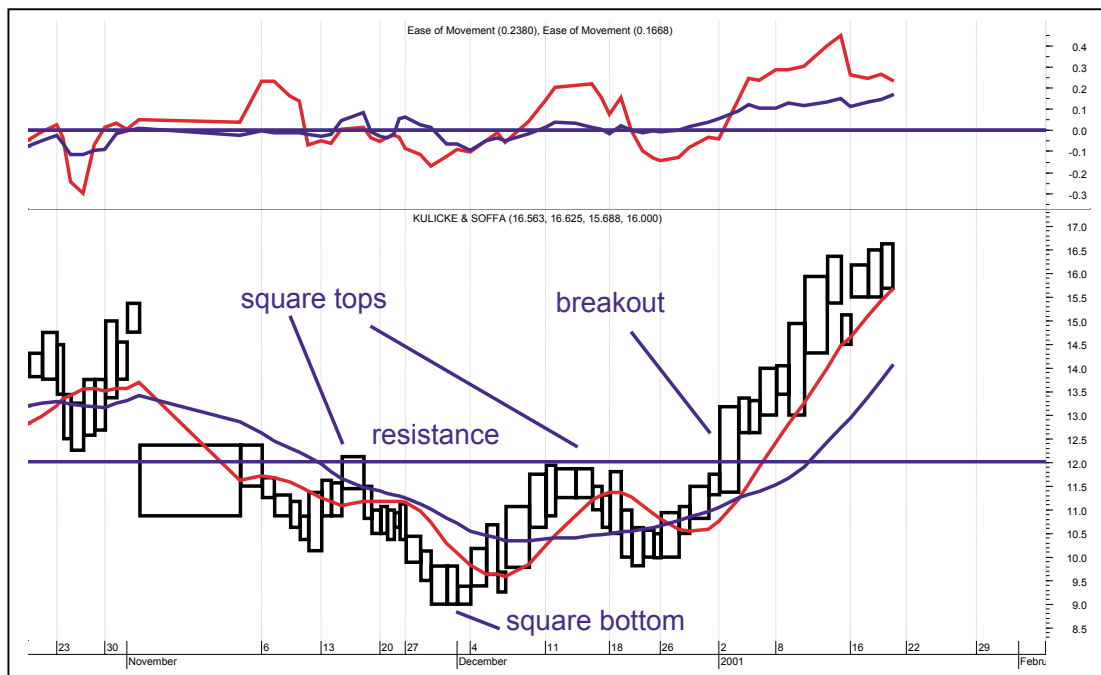
Often, though, we will see lows that look more like tops, in which we have a series of heavy volume days with a very tight trading range. Instead of a panic sell off, the decline ends with a gradual shifting from weakness to strength. When that happens a rounded bottom develops, which we often call a saucer bottom. This sort of low can be very profitable. It forms a wide base, and therefore is likely to lead to a substantial advance. The chart that follows pictures a typical saucer bottom. Notice also the impressive upside volume as it emerges from the saucer.



That upside volume out of the base would be a strong signal to cover short positions, and even to go long.

BUYING THE BREAKOUTS

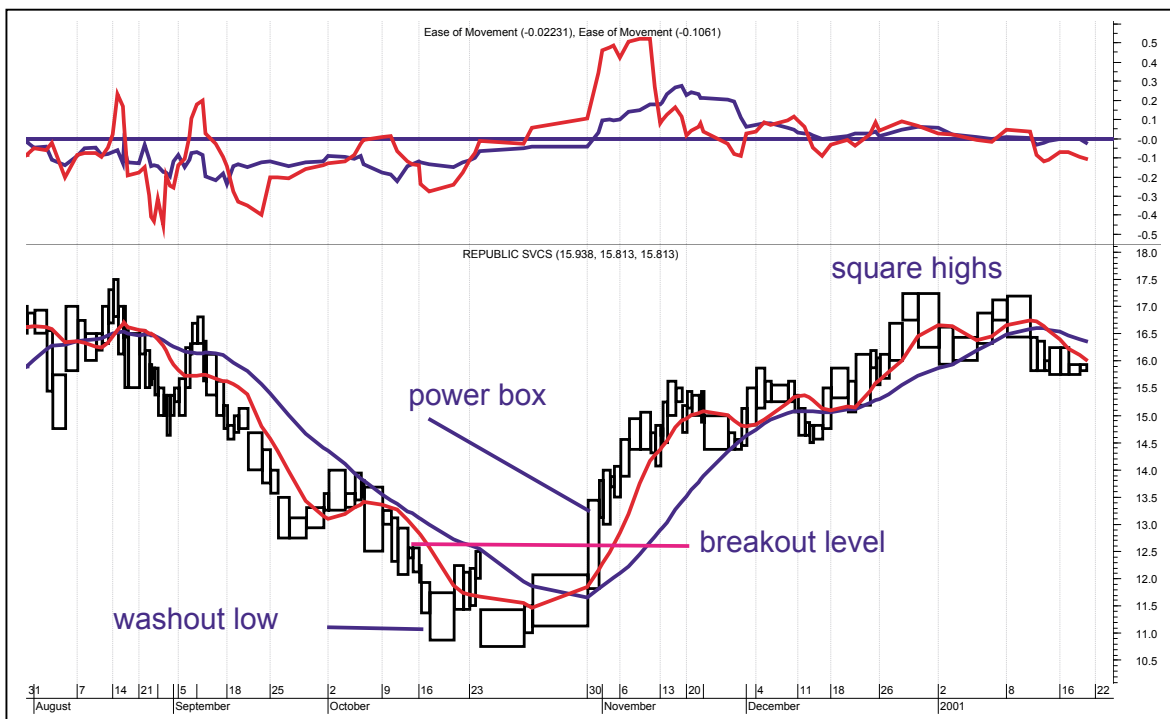
The classic technical picture that I particularly like to use for trading, is a stock that has had a long decline, given signs of a bottom, built a substantial base and has then sent a signal of strength. All of these earmarks are exhibited in both price movement and volume characteristics. On the stock chart that follows we are looking at a quite typical formation of this sort.



I have made a number of notations on the chart. The first is the square top that we saw as it tried to rally after a long decline. The heavy volume and lack of progress suggested that it was encountering formidable overhead supply, and could not get through. Then it went down to a level where we saw the same sort of square entries, but now on the downside. The next rally was more encouraging because, for the first time in months, volume was coming in as the stock went up instead of becoming heavier as the stock went down. But when it got back to the old resistance it again stalled, and made another series of square tops. The sellers were still there, and would not let it through the barrier. It pulled back again, but not so far, and the volume was lighter. We were still in a base area, but it was becoming more encouraging. Then, on the next rally it broke out! Notice the Equivolume box it made on the breakout: a tall box showing that it was moving well, but heavy volume showing power. The stock appeared to be on its way.

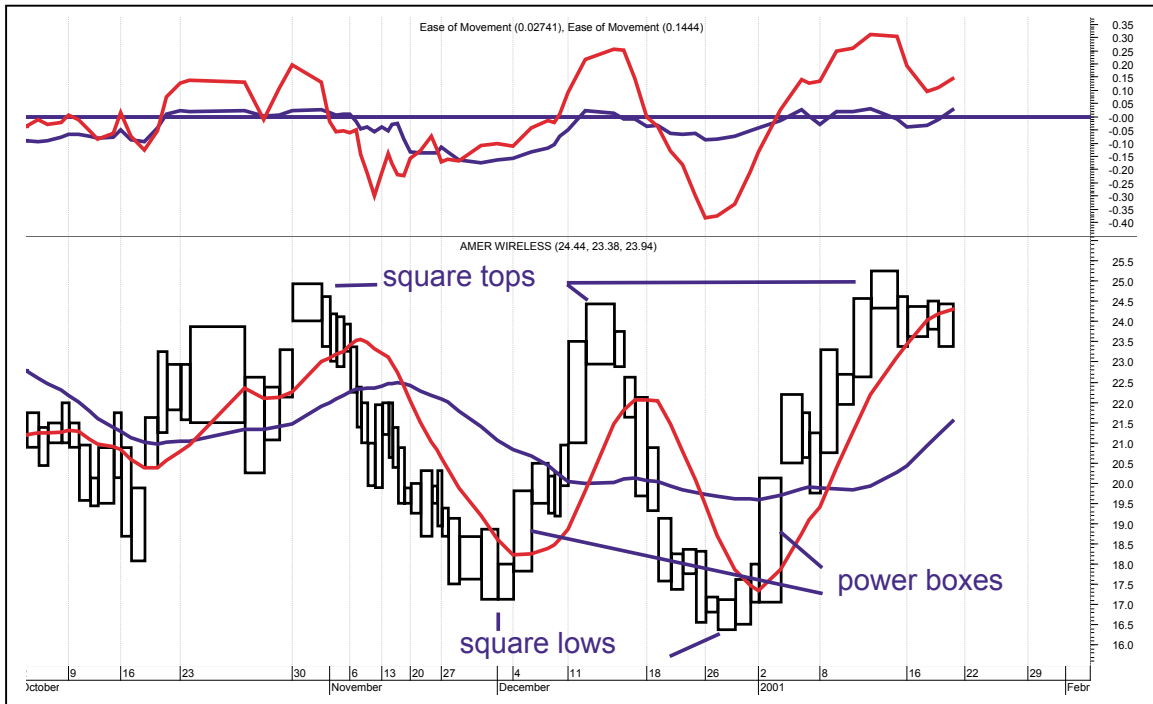
The breakout box is what I like to call a “power box”. A tall thin box that lacks volume as the resistance is penetrated is suspect. There does not seem to be enough conviction behind the move. A short and wide box through resistance is equally suspect, because it is obvious that there are many big sellers just above the old resistance level. But a tall box that also has width indicates a very strong situation. There are many aggressive buyers, and the sellers are toppling before them. That is the sort of breakout box we saw in the stock above, and those are the situations we should be searching for.

Lets look at another power box breakout and the results.



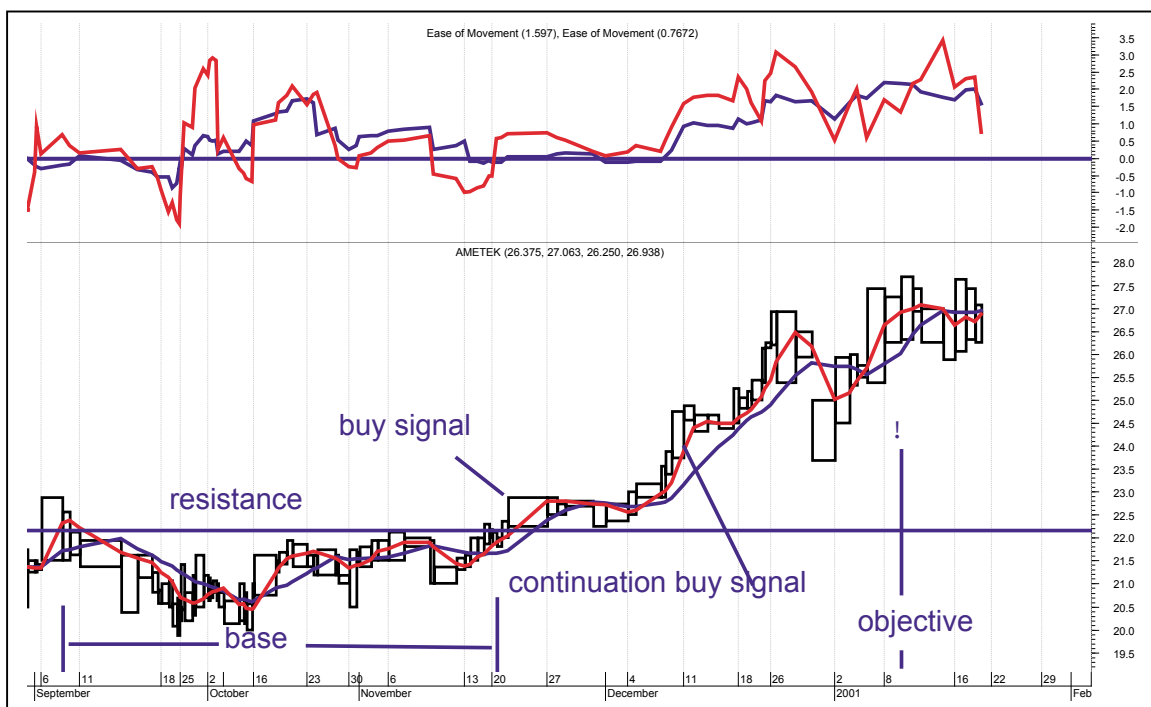
After a long decline the stock gapped down, and a day later it traded very heavy volume in a fairly wide trading range. That had the look of a bottom starting to form. Next it rallied on very light trading before dropping back to the old support area on enormous volume, creating an oversquare day. After two more days in the same bottoming area it moved sharply higher. It was a tall box with good volume, suggesting the stock had made a legitimate turn. Moreover, it went through the level where it had been turned back on the prior rally, making it look like a breakout from a base. In the next few weeks the stock went up about 35% before encountering heavy resistance. Finally, we see the square Equivolume entries on the highs. That was a strong hint that the advance was ending.

Below is a final example of power boxes to the upside. Also notice the typical square entries on both the highs and the lows for each cycle.



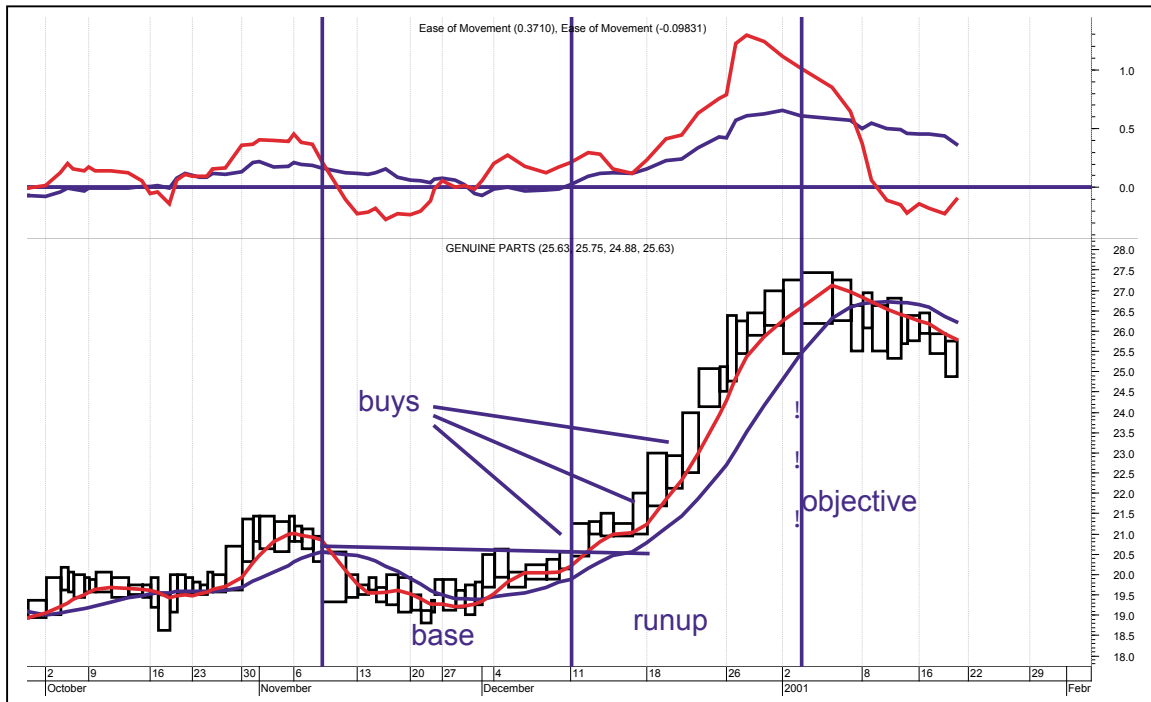
BUYING CONTINUATION PATTERNS

The other favorite signal for buying is a continuation of an earlier breakout. As with the breakout, we want to see heavy upside volume through an old level of resistance. Moreover, we want to be sure that the stock has the right volume characteristics. That is, it needs to be receiving heavier volume on advances than on declines. Thirdly, it needs to have the potential to move a good deal further. The stock must have enough of a base to suggest the advance is not likely over yet and that the objective is at a higher level. Determination of objectives, and the cyclical nature of stock that is implicit in the volume-to-volume relationship is covered more fully in the book "Volume Cycles in the Stock Market". For this discussion, understand that the width of the base is usually very nearly the same as the width of the ensuing advance. Similarly, the width of a top is about the same as the width of the decline that follows.



This stock built a very wide base lasting about three months. I have shown that base as the distance between the two vertical lines. It gave a buy signal as it came out of that base. Volume was much heavier as it penetrated the resistance. After moving sideways and then higher, it again had an upside power box a month later. I show that as the continuation buy signal. The two vertical lines show the width of the base. Remember, since this is an Equivolume chart we are really measuring an amount of volume not an

amount of time. I have measured sideways a distance equal to the base, and marked it as the objective. Since the second indication to buy came well short of that objective, it was a believable signal. Notice that the high came in just about where it had been forecast.



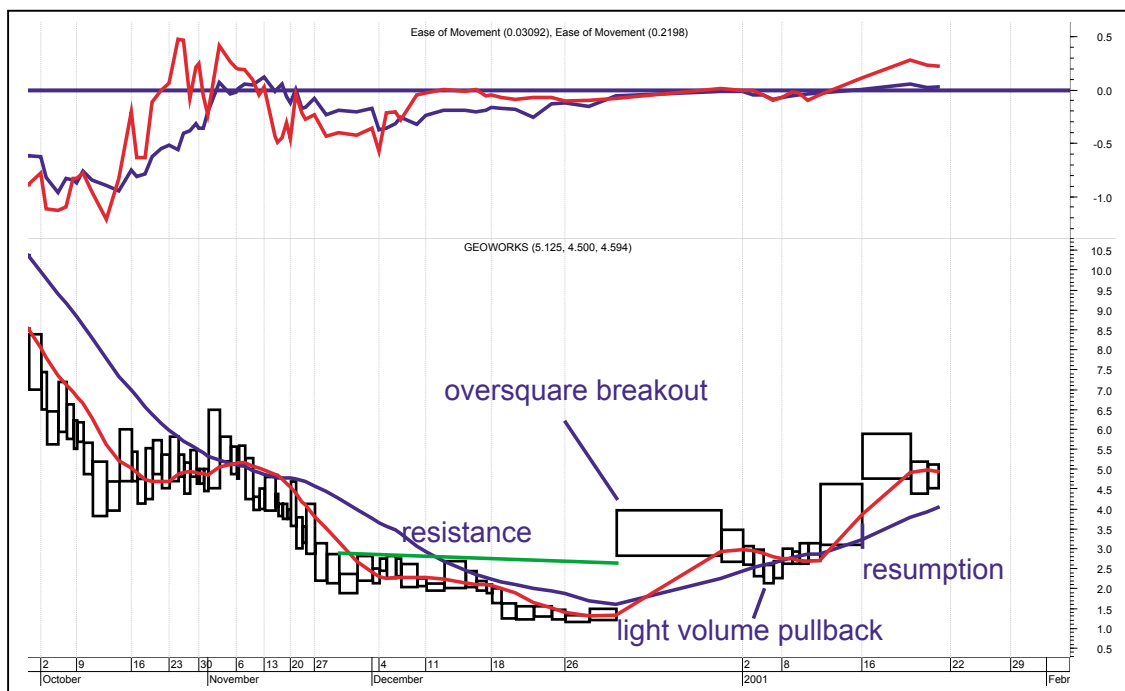
Here is another example of multiple opportunities to buy. Each time the stock ran through a resistance level volume expanded. Each time it pulled back volume contracted. The wide base justified a long advance. The stock finally encountered resistance and went square, suggesting the move was over. Obviously, the examples shown are chosen to illustrate the principles. Not all stocks behave so well all of the time. Therefore it is important to always have a stop order, or at least an idea as to what sort of action would say that a bad decision had been made. We will be looking at stop levels a little later.

Every buy suggestion that appears on the website is derived by looking for either a new breakout or a continuation pattern. Within the time frame we are using, they are the only formations that carry big odds of being correct. For example, in a longer-term decline there are often countertrend rallies, but they are usually on light volume and are short lived. Since the longer-term trend is down, the risks are too large to be buying such a formation. As we said above, thinking a stock is through going down is not reason enough to buy, either. The stock could be through going down but not ready to go up, meaning money might remain idle while waiting for the move to develop. The rea-

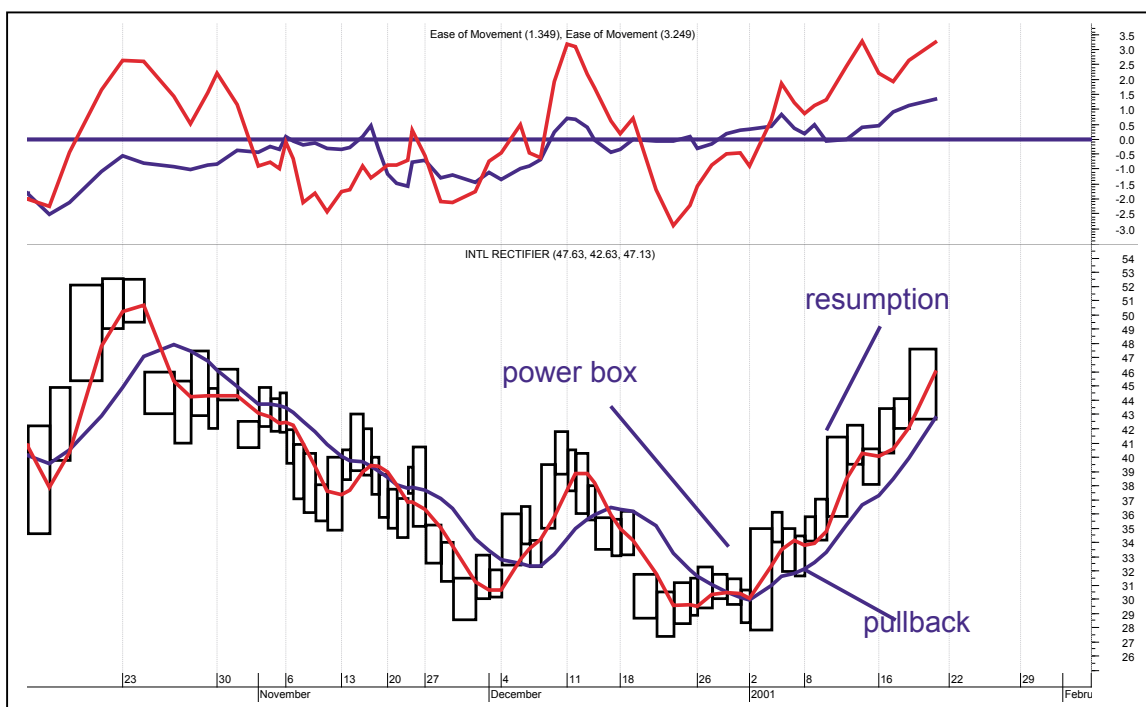
son for buying a stock is to participate in an upward move. The best time to buy the stock is when others have just started to. Big buying evidences itself in heavy volume and a wide trading range; a power box on the Equivolume chart. We don't ever want to be contrarians. We want to agree with others, but only very early in the move. The big volume move is usually caused by professional money coming in. Later in the advance the amateurs are buying. We want to be on the side of the pros.

There is one variation on this strategy that we do use however. In some markets, and in some instances, a power box is followed by a light volume pullback. That pullback is likely to return the price to somewhere near the breakout level. In a fast running stock, or a greatly oversold market, we sometimes do not see many such pullbacks. At other times they are quite common. They can often give us the opportunity to buy at a somewhat better level. Depending upon the stock and the way it is acting, we sometimes will suggest waiting for a pullback to buy. At other times, where it is less clear, we suggest taking a partial position on the breakout, another partial on the pullback and a third piece when the rally resumes.

On the chart that follows we see a case in which the breakout, while dynamic, was worrisome because it was so oversquare. It said that the move was already encountering resistance. Therefore, one would be inclined to wait and see if it would pull back some before going higher. Particularly important is to be sure that volume dries up on the pullback. It says that the sellers are running out of energy. The resumption of the advance should be accompanied by an increase in volume, as in the example. The big buyers are back in, and it looks as though they will run the stock higher.



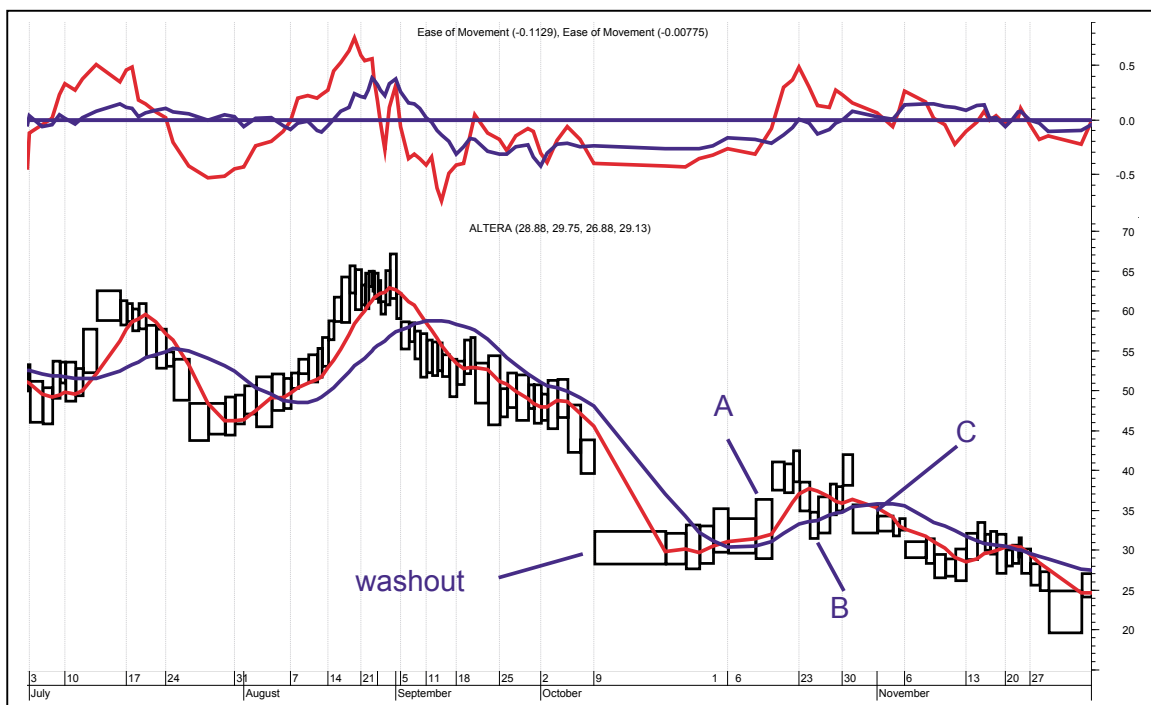
Here is another example, in which we see a typical lighter volume pullback before resuming the advance.



WHEN TO SELL

Before ever buying a stock it is desirable to decide where to get out. There should be two events in mind, the selling to take a profit and the selling to correct a mistake. Then, as time goes by and the position starts to move, it is necessary to continually reevaluate those decisions, and adjust them. Each position should be revisited at least daily; to be sure the situation has not changed.

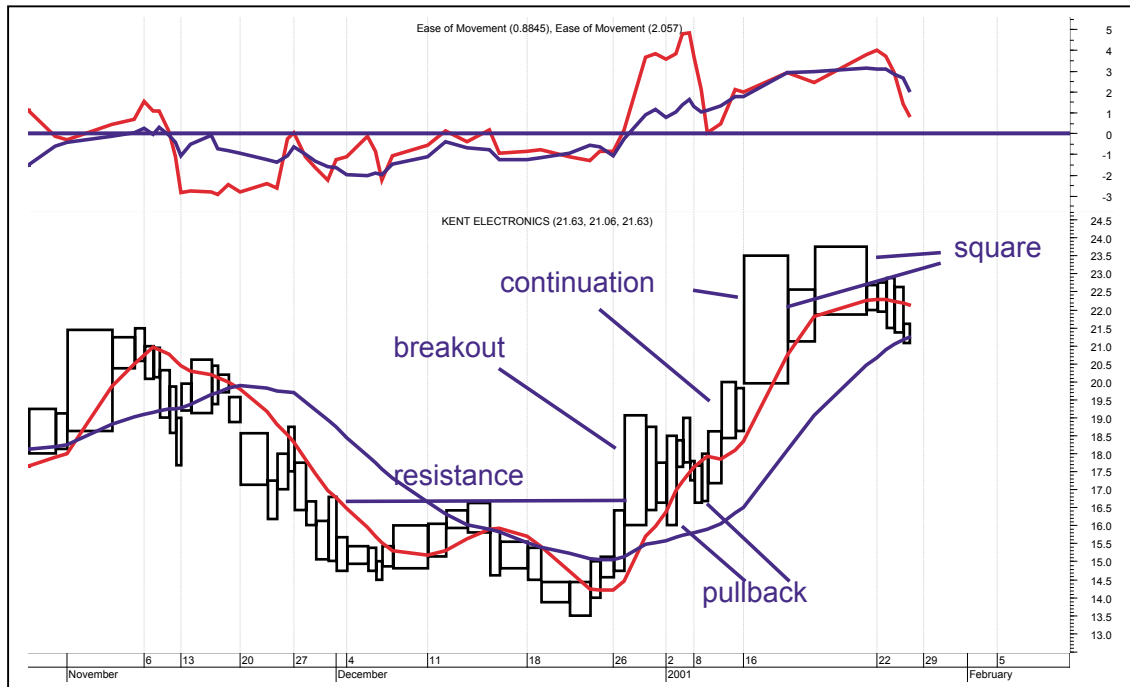
Lets first look at when to get out if we are wrong; and being wrong on many positions is inevitable. The best looking situations sometimes don't work out. But staying with a bad position can be disastrous. As soon as it looks as though the stock is not going to act as expected the position should be closed out. That means either having a stop order entered that will take out the position automatically, or having the discipline to admit a mistake. On the website, buy recommendations are accompanied by a suggested level for a stop order.



On the stock pictured above it looked as though it was a very promising buy. After a long decline there was a heavy volume washout, with an oversquare entry. After some base building there was a sign of strength at "A" that looked like a time to buy. The pullback to "b" was on lighter volume, suggesting the position was valid. But then the next rally was bothersome. It lacked volume, and could not penetrate the earlier high. At "C" volume became very large as it dropped. This was unexpected, and suggested

the stock was not acting right. A nimble trader might have thrown in the towel there. If not, there should have been a stop order below the prior low at "B". It would have been executed a few days later. Either way, the stock had told us that it was not acting as expected. That, rather than a percentage rule, should be the criterion for covering a position. In fact, not just in taking a loss, but also in any covering of a position, it should be based upon the observation that the move is no longer acting well. After a stock has moved up, and is showing a profit, it is still suggested that a stop be used as a discipline for getting out if the stock starts to do the unexpected. We saw in the section on tops that a clue to the end of a move is an oversquare day. That could be considered to be another case of "not acting right". Later we will look at some other technical analysis tools, such as gaps, support and resistance levels, flags, pennants, etc. Each of these tools is designed to help us to see what is likely and normal in a stock's movement. They will help us to know when a stock is acting "wrong" and should be sold. Even the work on objectives is meant to alert us to the unexpected. If a stock acts as we expect, we should stay with the position, but as soon as it acts wrong, it should be gone.

On the chart below we have a good example of the many features we have been talking about. Notice, though, how it acts after the strong advance out of the base. It looks as though it has penetrated another resistance area and is likely to move higher. But then it backs off with a somewhat square entry that is worrisome. The next day it tries to resume the advance, but is unable to, even though volume is immense. The result is a very square Equivolume entry. It is clear that something is changing. The unexpected has come to our attention. It appears to be time to get out. Besides, the width of the advance is just about the same as the width of the base, so our objective has been satisfied.



Knowing when to sell is not an easy task. A buy can be unemotional, but once a decision has been made to buy, there is a reluctance to admit being wrong, and a desire to take a profit to prove being right. That leads to less objective decisions. I have found, in my own trading, that I have to force myself to sell “too soon”. When I own a stock and it has moved with me, I get to like it. That allows me to make excuses for it. Abandoning a winner is like kissing off a friend. There is a tendency to give a winner more leeway than a loser. But that is a mistake. Just because a stock has gone up ten points after you bought it should not serve as a reason for allowing it to back off five of those points without selling it. I have had to learn to grit my teeth and abandon my friends as soon as they disappoint me.

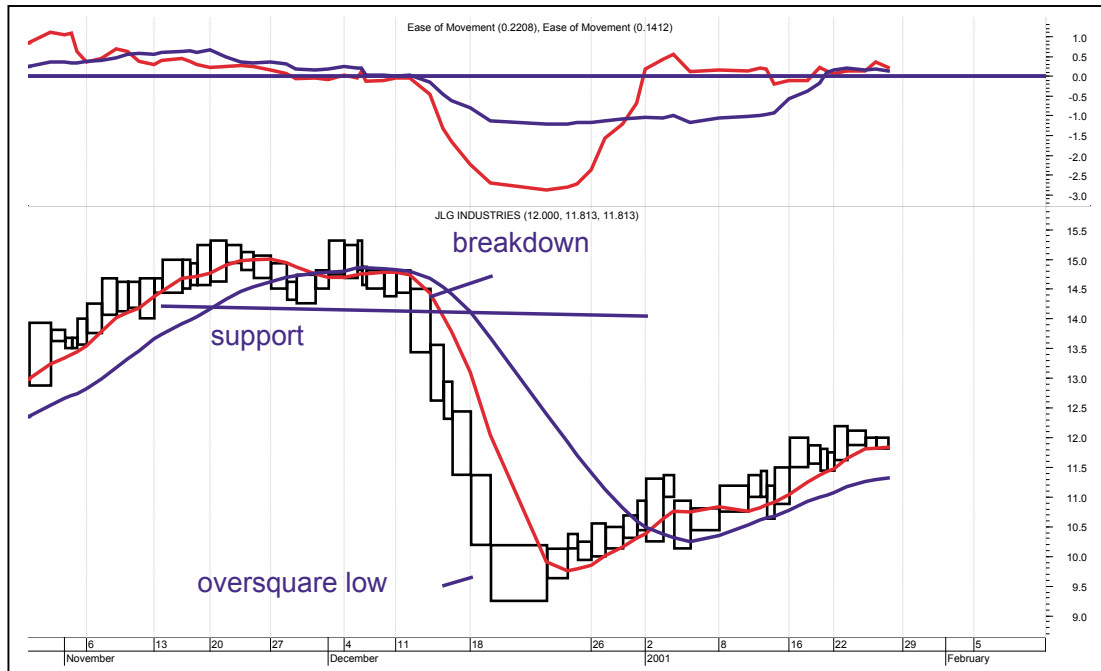
SELLING SHORT

An aggressive trader should be as willing to go short as to go long. There are two sides to the market, and they might as well both be used. It is often argued that the short side is more dangerous than the long side because there is no limit to losses. True, but a trader should never stay around long enough to find that out. As soon as a position starts to act wrong, the short should be covered.

In a way the short side is safer than the long side for a trader. That is because most up moves take twice as long as do down moves. Therefore, if you are long, the position goes with you slowly but against you rapidly. Conversely, if you are short, the position goes with you rapidly but against you slowly. You are likely to have more time to correct mistakes.

In shorting a stock using the Equivolume methodology, the principles are similar but inverted. In buying a stock we wanted to see a decline, followed by a base building period, and then a sign of strength. If we are going to sell a stock short we want to see an advance, then a sideways consolidation, and then a sign of weakness. Just as we did not want to buy just because a stock appeared to be through going down, we do not want to be short sellers just because it appears to have stopped going up. Remember that every trend has a better chance of continuing than it does of reversing. If we sell it because it appears to be through going up we are statistically fighting the odds. It is about a two to one chance that the consolidation will be followed by a resumption of the advance rather than a break to the downside. So, before selling we have to have information that tells us the trend has reversed.

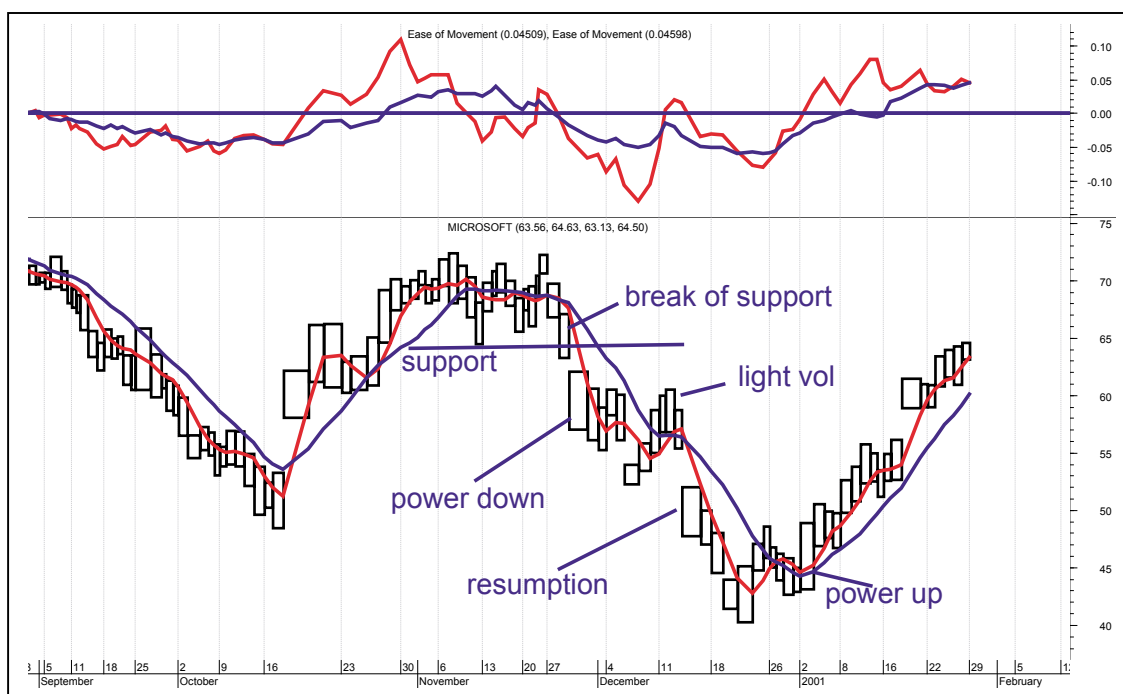
A sign of a top, such as a large oversquare box, is a very good reason to take a profit on a long position, but not a reason to sell short. The stock could languish for a long time in the sideways area, so the money would be inactive.



On the chart above we are looking at a good example of a successful short position. In the early part of the chart we see the last part of an advance. The start of the top building process is not easily noticed. But then it makes a second top at the same level and backs off to the support zone. But there is still no reason to be selling this stock until we get the power box to the downside. That is a definite breakdown, and a strong suggestion the stock will go lower. We might wait for a light volume rally to the breakdown level, but in this case, it never occurs. The subsequent drop is rapid and large, and culminates with an oversquare Equivolume entry. That is definitely a signal to cover the short position and take the profit. It is not a signal to go long. Perhaps you end up, later, buying at a higher price, but by then you have built a base and had a sign of strength.

The chart below gives us another good example of a short sale. This stock, Microsoft, had a fast advance in October, which then turned into a sideways consolidation. The pullback in early November established a support level for us to keep an eye on. That support was broken with a big trading range, although the volume was not particularly heavy. But the next day it gapped lower, and both volume and range expanded, producing a power box to the downside. It certainly confirmed the sign of weakness we had seen the day before. After a further slump over the next week it rallied, but on poor volume, suggesting the decline had further to go. The decline did resume, with another gap down and another power box to the downside. The stock fell from first sell signal to its low point, about 30%, in just about a month. Notice also the next

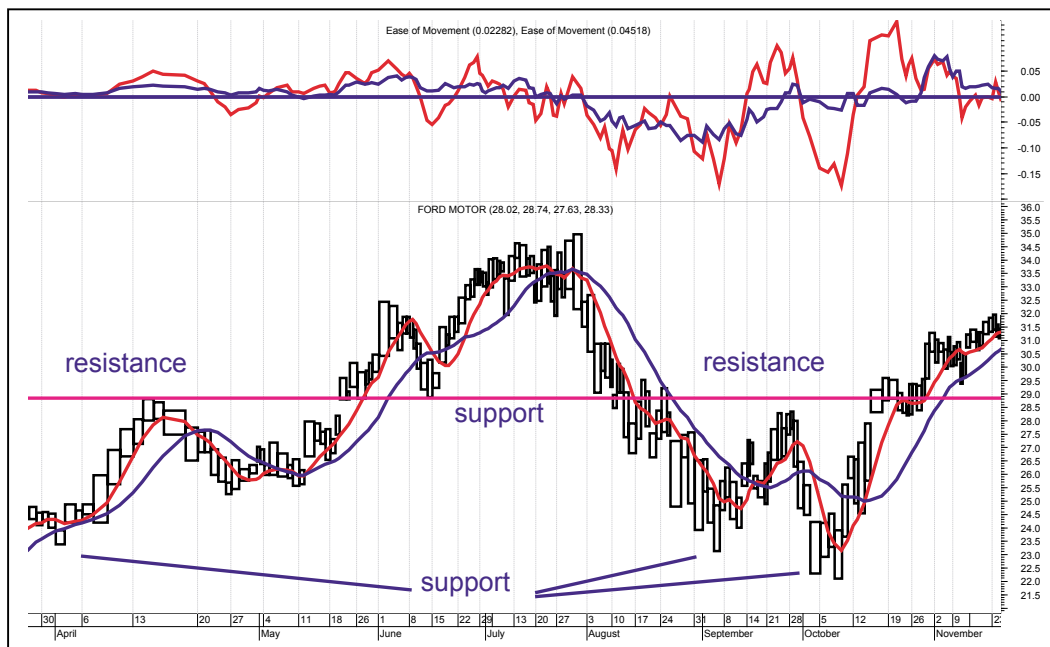
power box to the upside. It penetrates resistance and takes the stock right up to the level it had been in prior to the short sale.



In the long-term scheme, the market has gone up more than it has gone down. Recently it went through a seventeen year long bull market. That means investors have been better off owning stocks than they would have been shorting them. But traders are dealing with shorter-term moves. For them, a long-term bull market is of little consequence. There are waves within the tides that allow profits in both directions. Unless one is trading a tax-sheltered account that does not allow it, a trader should be as willing to go short as to go long. To not do so is to ignore half the opportunities that present themselves.

SUPPORT AND RESISTANCE

A basic observation of all technical analysis, be it Equivolume or an older method, is the reoccurrence of price levels. As a stock moves higher it will encounter levels that repeatedly turn it back. Often, after that resistance level is surmounted, the same level serves as support on declines. It happens enough so that we must pay attention to those levels. If a long position moves higher, as expected, and reaches an old resistance level it has to be watched very carefully. Here Equivolume can often be extremely helpful, since we want to know more than just where the price is; we want to know how much difficulty it is having in moving. The box shapes are often a clue. Square Equivolume entries at the old level are enough of a warning to justify taking profits.

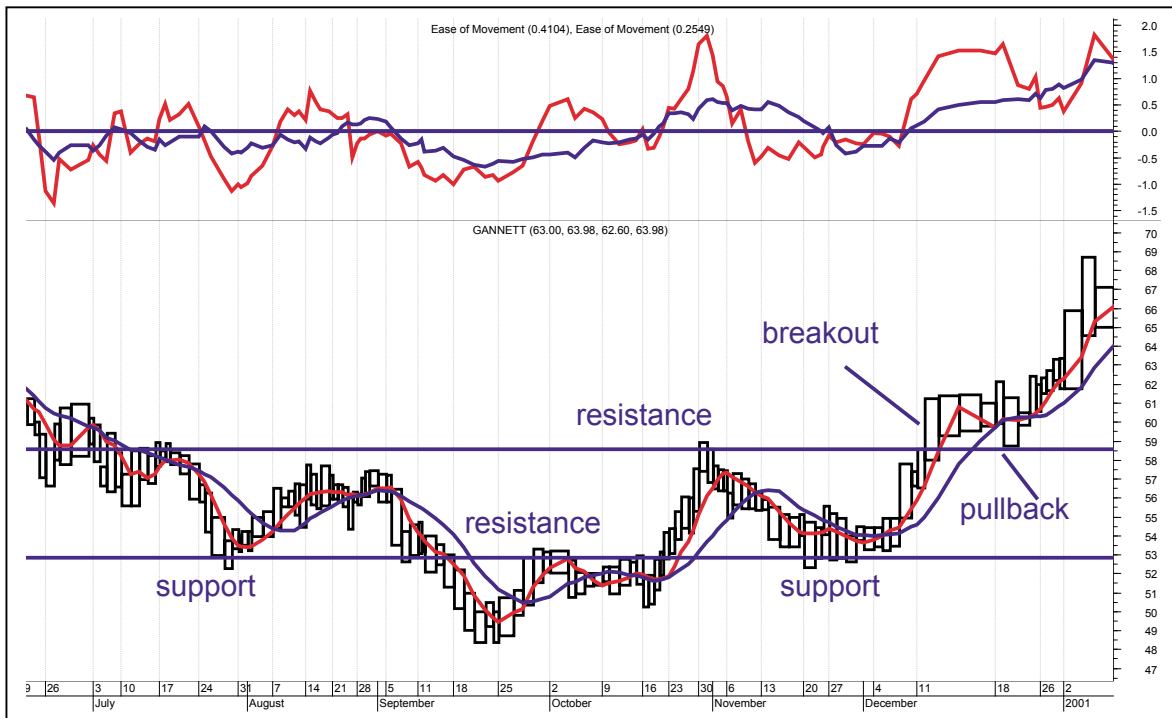


On the chart above we see quite typical action. Across the center of the chart I have inserted a horizontal line. Early in the period shown it served as resistance to upside progress. Later the stock moved up through that level, and subsequent declines stopped at the same level. So the old level of resistance had become a new level of support. After the stock moved back down below that line, it again acted as resistance on the right side of the chart. In addition, we see that there is a lower level of support that has tended to hold the stock up repeatedly. It was penetrated at the right side of the chart, but briefly, and in a manner we should have recognized as being climactic.



Here is a stock that gave a very easily seen sell signal. There was a strong support level that was broken with increasing volume and a widening range; a power box to the downside. After that it had a long decline that consisted of a number of stair-steps down. Notice how it would find support at a level, then rally from that level to the prior support level that had become a resistance level. Each drop was on increasing volume, and each rally was on decreasing volume, saying that the decline had further to go. Way to the right of the chart, though, volume became very heavy, and the range tightened up, thereby producing square Equivolume entries. It was an easily discernible signal that it was time to take profits on the short position.

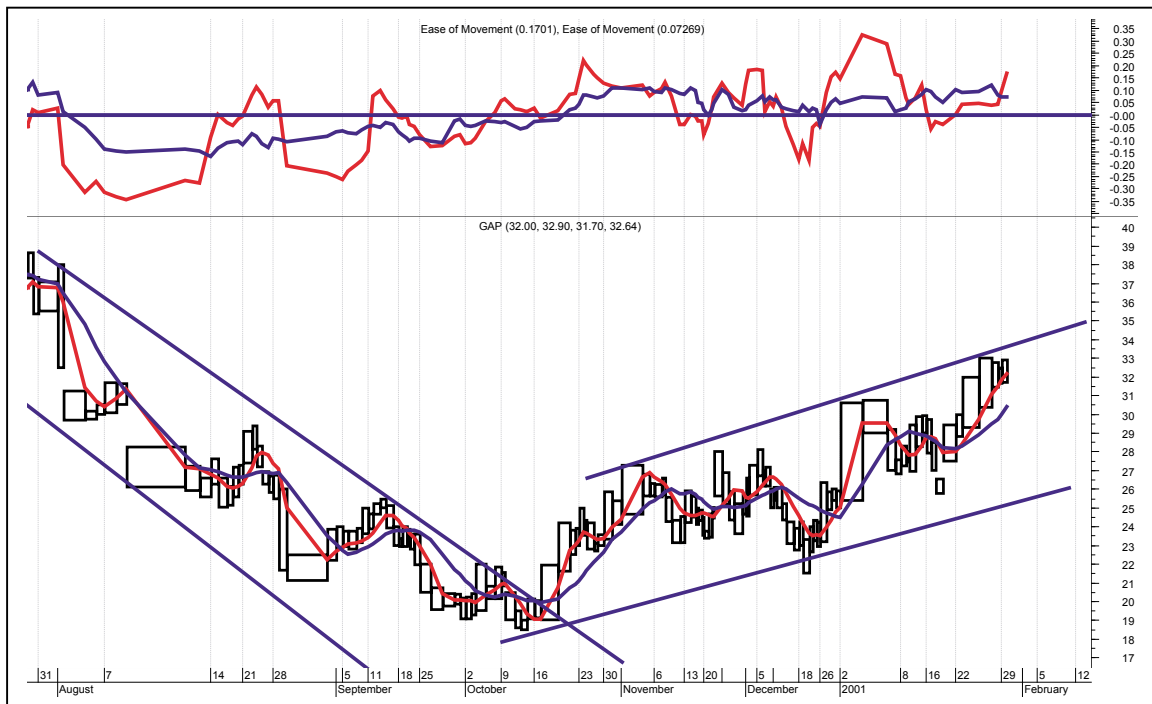
Support and resistance levels should not be used as indications to put on new long or short positions. They can, though, help to determine when to take profits. The one exception is that a stock that has a breakout will often move back to the breakout level. If one decides to wait for pullbacks before buying, or light volume rallies before shorting, then a return to the old support or resistance level is to be expected, and is a confirmation that it is time to put on the position. But it is not the primary reason for putting on the position; the power box out of a consolidation is the primary signal.



Here is one more example, now on the upside. Notice how it came back down after the breakout, and held right at the old resistance level, before going higher.

TRENDLINES AND CHANNELS

So far we have been looking at horizontal lines that define the tops and bottoms of sideways consolidation areas. But as prices move up and down they are also often contained within sloping lines. We tend to draw a pair of parallel lines, enclosing the price trend. However, the more important line is the line across tops in a decline and the line across bottoms in an advance. They show the levels where we have to become concerned. If we are short, we do not want to stay with the position if it moves out of its down channel to the upside. If we are long a stock, we want to cover the position if it breaks the lower ascending trendline, indicating a loss of momentum. In addition, of course, we will want to look at the type of Equivolume box involved in the reversal. Heavy volume and a big range is a much more bothersome signal than a light volume small penetration.



The above chart shows both a down channel and an up channel. In addition, we see here another example of volume emphasis. All the way down, volume increases on drops and decreases on rallies. All the way up, volume tends to pick up on rallies and drop off on pullbacks. Particularly interesting is the Equivolume box at the transition point. It is a typical power box to the upside. It penetrates the descending trendline, making it clear that it is time to cover short positions. But that box is not a signal to go long. It is only saying that the decline seems to have halted; it is not saying the stock is headed higher.

The buy signal is seen a couple of weeks later when another power box penetrates resistance after a base building period. In this case it means buying at higher level, but it is buying when there has been a sign of strength.



More often, though, there are trends within trends within trends. On the above chart we are looking at a longer time frame than previous examples, in order to see the various trendlines that can be inserted. The major trend is outlined with the two red lines. Inside that, we have a number of large price swings, each designated with a pair of green lines. Within those trends are a number of minor trends. I have shown a few of them with blue lines. For our trading purposes we will be trying to play the moves of the intermediate type. The very small moves, you will notice, are usually counter to the trend we are trading. They are the pullbacks during an advance and the rallies during a decline. They are very valuable, though, as an indication of the limits of the trend we are trading. Moreover, they tend to confirm that the position we are holding is still valid. For example, during an up move, where we are long, we like to see the pullback made with lighter volume, and usually getting even smaller as the correction progresses. Those pullbacks are the profit taking that needs to be absorbed on the way up. It is healthy and expected. If, however, the volume gets heavy on a pullback, it is a warning that the sellers are getting the upper hand. If the trendline is penetrated it says the sellers are too aggressive. We like light volume pullbacks that stay within the trend.

GAPS

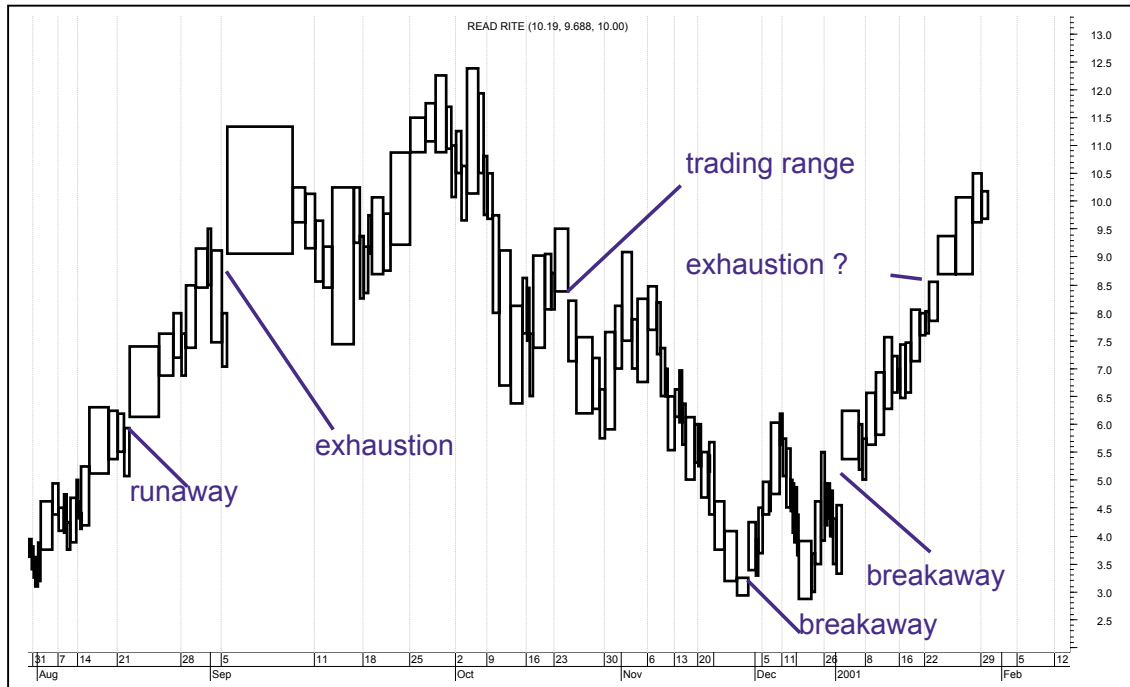
Often a stock will have a gap in its trading pattern; an area of prices where no trading has occurred. It happens when a stock opens sharply higher or lower than the prior day's trading range, and never moves back into that area. Classic technical analysis classifies them as one of four types, depending upon where they occur. They can be trading range gaps, breakaway gaps, runaway gaps or exhaustion gaps. Using Equivolume we find that the volume makes it far easier to see what kind of gap we are dealing with, and therefore, what we are likely to see for price movement after the gap.

A trading range gap usually consists of two boxes of about the same size and shape on both sides of the gap, and usually is not accompanied by the penetration of an important support or resistance level. It is a gap of little meaning.

A Breakaway gap is usually quite dramatic. The stock moves up or down out of a sideways area, with so much power that it leaves a gap behind. It is a power box, as we have seen earlier, but even more so. In a breakaway gap we see both volume and price range expand across the gap. That means, a small Equivolume box followed by a large Equivolume box, and one that is quite tall for its width. A breakaway gap is a strong signal to buy or sell, depending upon its direction.

A Runaway gap is seen when a stock is rising or dropping so fast that it leaves holes in the trading along the way. It is a sign of a very emotional move, and usually implies that the move has further to go. It is identified by two boxes, both large, and both tall for their width. It is like two power boxes separated by a gap.

An exhaustion gap is a sign a move is ending. It is characterized by a tall thin box followed, after the gap, by a short wide box. It shows us that a very powerful move has suddenly encountered a barricade to further movement. It is like the oversquare boxes we were looking at earlier, but preceded by a gap. It is usually a strong sign to close out a position.



On the chart above we see a number of gaps. They have been labeled to show what kind of gaps the box shapes say they are.

Some stocks form many gaps, and others form very few. But whenever a gap is encountered it should be considered and categorized. Gaps are a strong indication of where the price is going to go.

CONCLUSIONS

An aggressive trader needs to use every bit of information available, and must make unemotional decisions based on that information. But the deluge of fundamental information in the marketplace is overwhelming. Moreover, there is no way that a trader can see every piece of information that may influence the price of the stocks he is trading. And even if he could see all the information, he would still be lacking the most important ingredient, which is the psychological effect of that news. It is useless to know the news and not know how it is going to influence the thinking of all the millions of people who are reacting to that information. What is needed is a machine that will assimilate every known piece of information, ascertain the psychological response to that information, and apply it to the price of a stock.

Luckily that machine exists. It is the market itself. Every tiny bit of information that could influence and engender an emotional response does so. People buy and sell stocks in answer to those emotional responses. Those responses are reflected in just two final pieces of information, the price and the volume. All a trader needs to do, is observe the way in which price and volume are exhibiting themselves in the marketplace in order to know exactly how the world is evaluating all of the information known, or even suspected, concerning that stock.

Equivolume charting does not look at any new information; it just looks at the same information in a more easily interpreted format. It allows us to more easily ascertain how prices are changing, rather than just seeing that they are changing. It shows the internal dynamics of a stock. Volume is treated as an equal partner to price, rather than an afterthought at the bottom of the page.

None of the methods we have covered are foolproof. There are always going to be losses as well as gains. The objective is to have more good trades, and larger profits on the good trades, than losses on the bad ones. To do so calls for discipline and objectivity. That means not only reveling in the successes, but accepting the failures and moving on. It also means having the strength to quickly move out of a position as soon as the evidence says it is time to do so. It means no stock can be your friend or your enemy. It is just a stranger who can take you where you need to go. When you get there you pay the fare and get off. The stranger who is doing the driving does not care where you want to go. You have to know where he is headed.

Successful trading is not based on luck. It is based on knowledge and ability. I like the words of a song recorded by Kenny Rogers that say:

You've got to know when to hold them,
Know when to fold them,
Know when to walk away,
Know when to run.

You never count your money
When you're sitting at the table
There'll be time enough for counting
When the dealing's done.