Trading tactics

In almost 30 years in the money management business I have become more and more convinced that there are patterns that can be quite profitable. One of these patterns is the interaction between **stock prices and trading volume**.

Several “packets” of volume (periods of stronger-than-average volume) always precede a bottom in the market. As prices head lower, volume increases. Eventually the market stops declining. You can rest assured that this is a bottom worth trading. The size of the rally that follows depends on the number of packets that precede the bottom and their intensity.

In a downtrend a small packet of volume will cause a small rally with prices declining again to new lows. As the packets increase in intensity, rallies will become more pronounced and the ensuing correction will be smaller. Eventually a strong packet will signal again the beginning of a new tradable rally.

It is not unusual for volume to decrease as the market rises. As a result the rally stops and prices decline. This is a critical time. You need to wait for the next packet to appear and the market to bottom again. There is no doubt that the size of the rally depends on the size of the packet(s) preceding the bottom. The larger the packet(s), the more profitable is the rally.

As the market rises, you will experience two possibilities. Volume remains close to or slightly lower than the levels reached at the bottom of the rally. This is good news. The trend is definitely up and you will soon experience solid gains. Prices will go above the previous peak and then retrace about 50% of the rally with the bottom above the previous bottom.

The time to become cautious is when volume increases as prices rise. If volume spikes well above average levels and prices stop rising soon after the spike(s), the rally is over and it might be appropriate to sell.

Inevitably prices will start heading down as volume dries up. Watch the decline in volume. If volume declines in a meaningful way, the decline in prices could be serious. However, if volume declines and remains above average, prices will consolidate close to the previous peak and then will go up again as volume increases. But watch for a spike in volume following a sharp rise in price. The odds favor an important top.

This is not a theory. I wrote this piece on 11/30/01 as I entered a trade in Diamonds (NYSE: DIA) at 11:42 am and closed it at 2:55 pm. The reason I sold was because volume expanded strongly as the Dow Jones Industrial Average was rising. Eventually volume spiked and the Dow began to go nowhere. There was no doubt about it, the strong volume signaled the end of the move. I had a nice profit, so I decided to take my money off the table. And I was right because the market declined more than 30 points until closing time.

12-10-01