Volume Studies

As a preliminary to further studies, we sum up, in the following general observations, what we have learned in preceding sections.

Supply and Demand. Always keep these facts in mind: Prices move up and down in accordance with the Law of Supply and Demand. This is true of the stock market as a whole and of every individual stock which is dealt in on the exchanges. It is true of bonds and commodities.

> When demand exceeds supply, the price rises.
>
> When supply exceeds the demand, the price declines.
>
> When supply and demand are equally balanced, the market or a stock, or a commodity stands still. By this is meant: It fluctuates within a narrow range.

Traders and investors are influenced to buy and sell as a result of the news, earnings, dividends, reports, hopes, fears, and the tips and rumors that flood Wall Street every hour of the session. Whatever the cause of the selling and buying, the result is added pressure on the market, or support under the market. One's ability to judge the comparative support and pressure – supply and demand – is the measure of one's success in trading and investing.

Some of the supply or demand may be artificial, a result of manipulation; but this is an advantage to the expert investor and trader because the manipulator, through his operations, helps to define the trend, which is the line of least resistance.

Technical Position. A market (or a stock) is said to be in <u>a weak technical position</u> on the bull side when the buying power has been exhausted, either in a small or a large way. A campaign of distribution exhausts buying power in a large way because much of the floating supply of stocks is then in the hands of traders and the public. Sponsors and large operators have sold. Those of the public who still hold these stocks are potentially bearish factors because, having bought, they must sooner or later sell, and their selling will bring pressure upon the market.

This was the case in 1929. The whole market became saturated with stocks held by those who were looking for profit. Public buying power was exhausted.

When these holders started to sell, they found little market for their shares. As the price of stocks declined, more and more were obliged to sell, or were scared into selling. The load of stocks on the market increased. Margins were impaired all through the list. (*) Every seller helped to force prices down and thus weakened so many hundreds of thousands of accounts. The effect of this was cumulative. Increasing pressure bore down upon the market, which was totally unable to absorb the gigantic offerings. The result was a collapse and a panic that affected everybody in every line of business throughout the world.

> **This sort of thing can happen again despite present day (1937) margin regulations. People can work themselves into panic regardless of whether they own securities outright or hold them on 55% margin. Moreover, a panicky condition which would sufficiently impair even these wide margins might produce the same effects of cumulative liquidation as with lower margins, for*

> *when the point of exhaustion of high margins is reached, few traders are able to raise the funds needed to restore accounts to a sound marginal basis. They will then be compelled to sell, precisely as of old, when conditions are at their worst for the sellers.*
>
> *In any case, the automatic restriction of accounts, which occurs when today's trader allows the market to run against him, freezes public buying power which is the same as impairing margins and capital under former requirements.*

A weak technical position occurs in a proportionately smaller way when buying power is exhausted for the time being, as after an intermediate or a minor up swing. A common form of this condition (on a smaller scale) may be seen in the examples previously referred to as overbought positions and buying climaxes.

A strong technical position develops when liquidation has run its course, either for the time being or more lastingly. Those who could be induced to sell or were obliged to do so, have sold. The majority of stocks are in the hands of experienced investors, bankers, sponsors, syndicates and large operators. The sellers are weak; the buyers are strong; that is, able to carry what they have bought through whatever further declines occur. Such a condition usually prevails at the end of a big decline, a panic or depression, as in June 1932. Sometimes the finishing-up stages of a decline – weak holdings being sold to strong buyers – require many months. The public, or such of it as has learned to operate on the bear side, is generally short at the bottom, just as it is predominantly long at the top because the public operates with its ears and emotions instead of with its thinking processes. These amateur shorts are potentially bullish factors because they must eventually cover (buy back) what they have sold short.

The same conditions, though on a proportionately smaller scale, are prevalent when supply is exhausted on an intermediate or a minor down swing. It is then that the market develops the characteristically oversold positions and selling climaxes already discussed.

Oversold and Overbought Positions. As you can see from the immediately preceding paragraphs, oversold and overbought conditions are corollaries, respectively, of a strong and a weak technical position. In other words, an oversold position is substantially the same thing as a strong technical position; and an overbought condition is akin to a weak technical position. No precise definition can be given, whereby we may determine the exact points at which the market or a stock is *definitely* oversold or overbought. This must be determined as explained in previous references to these phenomena. The following loose definition will, therefore, serve our purpose.

Oversold Position. We consider the market, or a stock, as having developed an oversold condition when, as a result of its failure to experience normal corrective rallies or adequate resting spells during a down swing – or because of the too rapid acceleration of a reaction or a decline – the price reaches a position where it becomes highly sensitive to short covering and to a general withdrawal of experienced sellers.

Overbought Position. We consider the market, or a stock, as having developed an overbought condition when, as a result of the too rapid acceleration of a rally or an advance – or because of the lack of intervening corrective reactions or resting spells during a prolonged advance – the price reaches a position where it is vulnerable to realizing sales and subject to the danger of a general withdrawal of experienced buyers.

<u>Rallies and Reactions as Indicators</u> [NB. "indicators" of the balance between buying power and selling power.] When a stock rises 10 points, a normal reaction would be one-half, or 5 points. This does not mean that a stock must react 5 points after an advance of 10. It means that the extent of its reaction, after a rally or an advance is checked, should be regarded as one of the indications of its technical strength or weakness.

> <u>Strength</u> is indicated by a <u>smaller</u> reaction than one-half.
>
> <u>Weakness</u> is indicated by a reaction <u>greater</u> than one-half.

That is to say, when a stock declines 10 points, a normal rally would be approximately one-half, or about 5 points. A smaller rally would indicate technical weakness and a rally greater than one-half would indicate technical strength.

These indications should be closely studied. The tape is full of them every hour of the market session and the charts reveal them from day to day, week to week, and month to month.

<u>When a stock is "on the springboard"</u>. On the bull side a stock (or a group, or the market as a whole) is in this position following a period of preparation. This usually occurs at the bottom of a decline, though it also occurs after the price has been in a trading range following consolidation of a previous advance in preparation for a new mark-up. The greater the decline the more likely large operators will accumulate the stock and make it the basis for a bull campaign.

Preparation for a considerable rise usually requires several weeks or months, depending upon how much the operator wishes to accumulate and how much may be had from the sellers at prices he is willing to pay [NB. These days, with intraday real-time streaming charts, this preparation may take only minutes]. As he adds more and more to his line, the floating supply of the stock (that is, the quantity for sale at that level, not locked in investors' boxes) becomes less; any substantial demand for the stock would advance the price. The operator opposes an advance until he has secured all the stock he believes he can get. His opposition consists of large selling orders placed with several brokers and through them with the specialists; so that it appears that a lot of the stock is for sale just above the present market. Floor traders and outside operators who work on the stock market technique make inquiries before they buy any large quantity of stock such as : "How much is offered in the next five points up?" And while the specialists are not supposed to give out this information, it is often obtainable [NB. Nowadays one can obtain this information via Level II; whether it is real or fake is another matter].

The day comes when the large operator decides that market conditions are favorable, and he is ready to let the price advance if it will; or advance it himself by purchasing more stock so as to complete his line. If he has completed his line, he will bid it up and whatever he buys (net) in this process, he will sell on the bulges so as not to increase his line above the desired number of shares.

A stock is on the springboard on the bull side when the operator has completed his original line and is ready to let the stock advance. Up to that moment the supply has been artificial. He is ready to allow the demand to overcome supply. At this stage this is comparatively easy because he has mopped up all the floating supply at that level.

<u>Of all the times to take a position in a stock this is the best</u>. By waiting for this psychological moment you avoid having your money tied up, paying interest on inactive long trades, and losing opportunities in other stocks. Nearly every day some stocks are on the springboard ready for a sharp move up (this may mark the beginning of an important rise), or prepared for a plunge downward, which may be the commencement of a decline of 10, 25 or 50 points.

A stock (or group, or the market as a whole) is <u>on the springboard on the bear side</u>, of course, following a period of preparation, in this case distribution. This usually occurs at the top of an advance, but it also occurs after the price has been in a trading range, following a decline, in which further distribution is taking place in preparation for a new downward plunge.

Some people regard a stock (or the market) in this (springboard) position only when it breaks through an old line of resistance or support into a higher or lower field. I claim that <u>the beginning of the springboard move is at the bottom of a range of accumulation, or in the upper levels of a range of distribution</u> [NB. In other words, the time to act is while the stock, etc, is in the springboard position, not after it's broken out.]

A Study of Volumes

Much can be derived from a study of the volume of stock bought and sold in the whole market, as well as in groups of stocks and individual issues.

<u>A small volume</u>, that is, little activity in a stock, indicates that it is being neglected by traders and the public. When this small volume occurs at the bottom of a considerable decline, or at the bottom of a reaction or small dip, it usually indicates a lack of pressure; a drying up of the selling.

Dullness may be induced for the purpose of accumulation. Traders may pull out all their orders to see what the stock will do if left to itself. If they wish to buy, they take what is offered without bidding for it, never taking all there is, but always leaving some on the offered side to keep the price depressed: If 500 shares are offered at a certain price, they will take 200 or 300. They continue this process until they have acquired a substantial part of their line, after which they may begin to bid for all they can get up to a certain point or until they see that they are attracting an outside following. Then they will withdraw their orders and let the stock sag and turn dull in order to deceive the public into thinking there is no further interest in it.

<u>A small volume may have a different meaning at the top of a rise, or a rally, or a small recovery</u>. This frequently is a bearish sign. It indicates that demand has been filled, or has dried up. The stock will probably go lower because demand is lessening and supply will likely overcome it.

There are exceptions to the above indications, however. Thus a small volume and narrowing into small price movement after a rise may mean that the stock is resting and digesting its previous gains, instead of reacting, prior to a further advance.

Therefore, in judging volume indications, we must always be careful to take into account the action preceding a particular volume indication as well as all of the other technical influences prevailing at the time the volume indication is given.

<u>Dull periods</u> generally correspond to the end of a chapter in a book. A new chapter begins sooner or later.

<u>**An increase in volume** of trading usually is very significant</u>. When volume builds up fairly consistently on an advance, a further rise may be expected. On a decline, a tendency toward increasing volume or failure of volume to diminish materially usually indicates lower prices.

<u>An unusual increase</u>, that is, a sudden surge in volume, generally indicates the culmination, or approaching culmination, of a movement.

Whereas <u>bear markets generally terminate in narrow price movements</u> to the accompaniment of <u>low volume and listless trading</u>, <u>bull markets terminate</u> in relatively <u>wide price swings</u> accompanied by <u>high volume</u> and more or less <u>feverish activity</u>, although volume may be less in the later than in the earlier stages.

It is *the change* from dullness to activity (regardless of the absolute, i.e., the actual volume), or the reverse, which is important; and *the manner* in which the change occurs. *These changes put us on guard to watch for further indications which will either confirm or deny the direction of the trend in which the change occurs*.

Suppose a stock were traded in at the rate of 2,000 shares a day for many days, within a range of 2 points. This would be merely a traders' market in that stock. But if it should break down through its former supporting line, and the volume should increase to 3,000 to 4,000 shares a day, this would be a relatively large change, indicating an increase in the supply sufficient to overcome the proportionately smaller demand. The volume of stock wanted by buyers may not have shrunk, but the increase in the quantity coming to market would be more than these buyers were able to absorb. So, the price would decline, and the effect of its declining under these conditions would be to induce more people to sell, thereby adding to the supply.

If a stock advances 5 points on transactions of approximately 60,000 shares a day and on a two point reaction the volume drops off to about 15,000 shares, the indication is that comparatively little stock is for sale, and that it is merely having a resting spell. Those who want to get out can do so. Indication of a further advance would be a gradual dropping off of this volume during the reaction until hardly any trades in that stock appear on the tape (or volume becomes quite small on the chart). But, when the volume again increases and the price advances, especially if it goes through the former high, a further material upward move may be anticipated.

The above paragraphs are intended merely to give you the general idea of what to look for when studying volumes. It is not feasible to lay down fixed rules for interpreting increasing or decreasing volume. Such arbitrary rules would be more deceptive than useful or reliable. They would have to be qualified by too many exceptions. You will appreciate the reasons for this as you continue with your studies, if they have not already become apparent from what you have learned so far. Remember: Stock market technique is not an exact science. Prices are made by the minds of men. In drawing deductions we must play the role of detectives, seeking clues by judging the psychological reactions of all of the buyers and all of the sellers, weighing their motives through observation of the circumstances leading up to and existing at the time a *change* in volume occurs.

Therefore, instead of attempting to formulate rules for the treatment of volume we shall develop this important subject more fully through additional practical illustrations in succeeding sections.

First, however, let us consider the following useful, if homely, analogy to further clarify the significance of volume behavior and the way to interpret it properly. Thus, volume is to the price movements of stocks as gasoline is to the automobile. If you step on the accelerator of your car, giving the motor more gas, the car will start to travel faster. The more gas you feed it the greater will be its momentum. Now, when your car has acquired considerable momentum, if you throw out the clutch and coast, your car will travel a considerable distance on its acquired momentum. On the other hand, should you merely give the accelerator a gentle tap, releasing it immediately, you will not give the car a great deal of momentum and, hence, it will not roll far if you allow it to coast.

This analogy applies to the stock market in the sense that, if volume increases temporarily, the price movement has been given a little gas, hence that particular move is likely to die out quickly because it has not acquired momentum. On the other hand, if volume begins to expand, continues to increase consistently, growing larger and larger, then we have an indication that the public is participating; that the price movement is getting more and more gas; that it is building up momentum. Under these conditions, the movement naturally tends to perpetuate itself and does not reverse as rapidly or easily as in cases where the volume increases are small, temporary or isolated.

It follows from the above that the daily volume of trading affords a very good clue as to the extent of the public's participation or the willingness of traders and the public to follow a given price movement, and to the probable momentum of the movement. For instance, when the daily volume of trading in the market as a whole averages around, say 700,000 to 500,000 shares or less, the indication is that there is little public participation and that the trading has become largely professional. Accordingly, should volume increase suddenly in one day to, say, 1,000,000 or 1,250,000 shares, the strong probability is that this abnormal expansion, being temporary, will mark a temporary or perhaps a more important turning point. On the other hand, if volume tends gradually to build up from, say, 1,000,000 to 1,500,000 and then to, say, 2,000,000 shares – that is, volume builds up fairly consistently – then we have an indication that the public is coming into the market; that the price movement then in progress is likely to carry on for a considerable time; that the market is not likely to reverse its movement sharply or suddenly until its accumulated momentum is checked by the application of braking power, expressed in flattening out of the movement; that is, no material further progress with volume still relatively large.

The figures mentioned above, of course, are not meant to be used as a permanent standard of comparison against which you may measure the daily volumes of future markets. They are used merely to emphasize the principle that it is the *relative change* in the volume of trading, rather than the mere magnitude of the daily turnover, that is significant. Thus, if a condition should arise wherein the daily turnover should run between 200,000 to 300,000 shares over a considerable period of time and a sudden increase should bring a rise to 500,000 or 700,000 in one day, that would then be a significant change. And, if volume should gradually build up to, say, 750,000 to 1,000,000 shares after such a period of 200,000 to 300,000 share days, such a consistent increase might indicate public participation, notwithstanding the fact that public participation in other years may l have been measured in terms of four to five or more million shares (as in 1926-29); or two to four millions (as in the early '30s).

The whole theory of supply and demand is briefly but clearly shown in the above paragraphs. The principle is old; it is easy to understand. Very few people apply it.

Always remember this: <u>An increase or decrease in volume is significant</u>. Gradual or sudden increases or shrinkage will assist you in detecting turning points; determining the trend; when to open or close a trade; when to change your stops; when a move may be culminating or about to culminate.

<u>Volume of Individual Stocks</u>. What has been said above about the market as a whole applies generally to the volume behavior of individual stocks and groups of stocks. However, since the action of individual stocks reflects the purposes of the interests who are dominant in them, we frequently find individual issues exhibiting habits or characteristics peculiar to themselves. We must study these habits so we may take them into account when making deductions. For instance, some stocks tend to top out their moves on heavy volume, others on relatively light volume; some tend to bottom out on heavy volume, others on light volume. Again, there are many which may move more or less independently of the market for long intervals; some that swing widely on very small volume; and others that move slowly or conservatively on relatively large volumes.

<u>Types of Sponsorship</u>. Some stocks are actively sponsored while others have passive sponsorship. Issues in the former category are those which are habitually active, tending to swing readily with rallies and reactions, advances and declines in the general market and having relatively heavy daily turnover, in short, the speculative favorites.

Passively sponsored stocks are those which are prone to swing in narrow ranges, participating sluggishly or not at all in the swings of the averages for long periods of time.

The actively sponsored stocks exert a considerable influence upon the market as a whole because traders watch the action of these issues for cues to the trend of the whole list. Passively sponsored stocks lack this quality of leadership.

Now and then certain passively sponsored stocks may be brought to life and whirled upward so that their sponsors can realize a quick turnover designed to reimburse them for the cost of maintaining a satisfactory market between moves, but the objectives of such campaigns are apt to be limited as a passive management is not so much concerned with speculative exploitation as with a desire to maintain the investment status of stocks under its wing.

A stock may pass from one class to the other, but it usually takes the public at large a long time to sense the change. This explains why so many people continue to operate in, and eventually find themselves hung up with, one-time speculative favorites now become dormant. Sometimes, also, a stock may pass from one category to the other and back again. A change in the character of sponsorship may be indicative of a change in the investment or the speculative quality of a stock.

The alert investor who makes it his business to keep abreast of significant technical developments is able to read the intentions of these dominant interests without prejudice, knowing that a stock, by its own action, by a change in its habits and especially its volume behavior, will usually disclose what may be expected of it.

And should he find it difficult to single out the individual stocks that are most likely to move soonest, fastest and farthest when he has arrived at a decision respecting the general market's trend, he will seek to secure a substantial slice of the indicated move by spreading his funds over five or more of those issues which, by their recent habits, have revealed active management. Chances are that a reasonable percentage of these will move, inasmuch as an active sponsorship is likely to take advantage of the trend by pushing its favorite into public notice.

Price vs. Quantity. The sponsorship of most low-priced stocks is passive or inert (usually until the late stages of a major bull market) because these issues attract the largest following. And this is so because the public nearly always thinks in terms of price and the maximum number of shares it is able to carry. Active managements dislike to move an issue in the face of a large following – they have nothing to gain by giving the public a free ride. The big fellows prefer to let outsiders in when it will serve their purpose best, namely, when they are actively marking up and distributing. If they see a chance for a good move, but find too much company in their stock, they will first try to shake out, or tire out, the premature bulls.

Higher-priced issues move more easily, as a class, than low-priced stocks for the above reasons. The public is afraid of high-priced issues and avoids them anyway because it can't get loaded up with 100 share lots of the better grade stocks.

Of course, experienced investors know that price alone is not a sound criterion of quality or value. A high-priced stock may not indefinitely remain a safe investment. But, as you acquire understanding, you will recognize that your only concern should be with the possibilities of a substantial *change* of price, hence with the number of points any stock may move. And so, instead of basing your selections, as most people do, on the maximum number of shares you can fit to your pocketbook, you should base them on the indicated maximum number of points profit you can see ahead, as shown by your own analysis.