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# TRADING ON VOLUME

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**THE KEY TO IDENTIFYING  
AND PROFITING FROM  
STOCK PRICE  
REVERSALS**

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DONALD  
CASSIDY

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**McGraw-Hill**

New York Chicago San Francisco Lisbon London Madrid  
Mexico City Milan New Delhi San Juan Seoul  
Singapore Sydney Toronto

## Library of Congress Cataloging-in-Publication Data

Cassidy, Don.

Trading on volume : the key to identifying and profiting from stock price reversals / by Donald Cassidy.

p. cm.

ISBN 0-07-137604-6

1. Stock exchanges. 2. Stock exchanges—United States. 3. Stocks—Prices. 4. Stocks—Prices—United States. 5. Stock price forecasting. I. Title.

HG4551.C325 2001

332.63'2042—dc21

2001031691

# McGraw-Hill



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2 3 4 5 6 7 8 9 0 DOC/DOC 0 9 8 7 6 5 4 3 2

ISBN 0-07-137604-6

*Printed and bound by R. R. Donnelley & Sons Company.*

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*To members of the  
Market Technicians Association  
and of  
The American Association of Individual Investors*

## ACKNOWLEDGMENTS

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**M**any individuals have been helpful along the way as I shaped the thinking and conducted the research that made this work possible. One always hesitates to name some for fear of inadvertently slighting others.

Stephen Isaacs of McGraw-Hill was instrumental in carrying the torch for this concept after others had earlier considered it too radical and perhaps of narrow interest.

Donna Whittington and Denis Payne were of great help in introducing me to the Market Technicians Association community and to its resources. I owe special thanks to Shelley Lebeck, the MTA's librarian, for allowing me access to their trove of old and recent publications on technical-analysis subjects.

Chris Bouffard of American Century Investment Management, a long-time friend and former colleague at Lipper Inc., was a patient listener and a valued sounding board as these ideas formed and coalesced. Jeff Walker, an excellent trader and webmaster of [www.lowrisk.com](http://www.lowrisk.com) and of [www.investormap.com](http://www.investormap.com), has been a ready supplier of ideas and data sources and valuable insights.

Joe Kenrich, now retired from the New York Stock Exchange, and Ann Price, who assumed the role of Archivist there, were most gracious in sharing trading-volume data. Chief statistician Pete Frien of Dow Jones, likewise, was very helpful in saving me many hours of laborious data acquisition by supplying detailed historical volume information via spreadsheet.

Current and former Lipper colleagues who were patient with my heavy use of vacation days as I wrote on deadline; they cheerfully picked up part of my time-sensitive load in helping with media inquiries. They are Ed Rosenbaum, Tom Roseen, Traci Gardner, and Joe Thurston. Jamie Wasserman provided me with crucial insights on the use of MetaStock and a helpful introduction to its Equivolume charting feature.

Members and program chairs of various investor groups in Colorado, Arizona, Michigan, North Carolina, Florida, Alabama, Ohio, and metro Washington DC provided highly engaged audiences for my early talks on this subject and in the process raised challenging questions and useful refining insights. Special thanks go to my long-time friend Wayne Baxmann of Texas for his ongoing support.

Last but certainly not least, my wife Belita Calvert has again been unreasonably patient with my gobbling up nights and weekends I know she would rather have spent sitting together in talking and reading—or even, perish the thought, getting away on a real vacation. Her understanding of my passion for this work has been a great comfort and help, as in my earlier book-writing immersions.

I thank you all and hope you will find the work as it has emerged herein to be worthy of your contributions.

*Donald Cassidy*

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**PART ONE**

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# Central Concepts

Theory and Action



## CHAPTER 1

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# Volume Is the Cause, Price Is the Effect

**I**ncredibly, trading volume is a hugely rich body of useful information about stocks that is widely ignored. To overlook the highly informative stories that volume tells about an individual stock's—or the broad market's—current condition and its future price prospects is deliberately to forgo half the free technical analysis information that the market offers you every day. No one should keep such blinders on. To do so would be financial folly.

In forecasting the weather, what meteorologist would note temperature and humidity but ignore wind and barometric pressure? None who expects to remain employed. In making a buy or sell decision, would a fundamental analyst study a public company's industry, management, competition, products, and financial statements and then ignore the price per share at which that firm's stock was trading? Of course not! That fundamentalist needs to know both parts of the equation, value *and* price, to make a fully informed decision. In an exactly parallel way, however, an extremely large majority of technicians study everything about price (change, volatility, correlation, trend, acceleration, divergence, momentum change, highs and lows, breakouts) but inexplicably have a huge, self-created blind spot: They pay no attention to trading volume.

The volume now in your hands (pardon the pun!) aims to provide you with a whole set of additional tools for analyzing stocks—intellectual weapons that investors and traders with whom you compete literally do not think about and therefore have no chance to use. Every day, and indeed every minute or hour that the stock market is open for business, two types of technical analysis information are being generated: data on price *and*

data on trading volume. You are about to cease ignoring half the facts and will now embark on an eye-opening mental journey: You will find out what trading volume tells an astute observer about a stock. Having performed my own personal and family portfolio management using the added information dimension that volume brings, I can predict that you will be pleased to have invested the hours ahead in adding this entirely new aspect of technical analysis to your array of tools for making decisions.

Let us begin. We must start by looking briefly at what technically minded traders actually do, and why. Then we will use the balance of this first chapter to illuminate what trading volume means and how you can use it to deepen your understanding of stock price potentials. I should tell you, right from this early page, where I come from in terms of investment philosophy. I became fascinated with the stock market in the late 1950s as a young teenager. A math teacher created a classroom investment contest; the fact that I nearly won added excitement to the intellectual joy I had immediately found in playing the game. From that time my career goal was to participate professionally in the investment world, and definitely on the research rather than the sales side. All the years since my high school graduation have blessed me with the opportunity to earn a living doing something I love—a wonderful situation I imagine only a small minority of adults enjoy. After taking a degree in finance from The Wharton School, I have spent over 30 years studying the stock market from every angle I could. Here is what I have learned and believe:

- Investing in stocks is potentially hugely profitable. Consistent success comes not from luck but from ongoing hard work. Wild times like 1998 to early 2000 are rare exceptions and not the rule.
- In the long run, fundamentals (corporate performance in context of economic variables such as inflation and interest rates) determine the *values* of securities.
- Every day between now and “the long run,” investor psychology drives people to buy and sell, and the results of those human actions are the *prices* of securities, which seldom equal their values.
- Individual investors have a choice to buy and hold passively, which predictably produces average results *if* they never panic or become overconfident and change their behavior.
- Those who work hard at investing successfully should expect to outperform the “averages.” Such performance is possible either by knowing what companies will remain winners for a lifetime (unlikely) or by buying below value and selling above it.  
Translation: Winning requires timing.

- Timing well is definitely not easy. Neither is it impossible. The market is usually not efficient, though most academics wish it were. Prices definitely are not random, as random-walk academic convention traditionally has held. (If the market were efficient, all fundamental analysis would be in vain because no one could beat the others, as everyone would have the same, complete information). The efficient-market, random-walk proponents have constructed a view of the investment world that consistently fails to study price in *the context of volume*. More will be said about these points in Chapter 2.) In reality, successful timing, while not possible every moment, every day, or every month, is possible *on average* for those using a full array of intellectual tools.
- If you believe markets are efficient and prices are random, then you should save your time and energy and learning expenses; just buy index funds. However, if you are willing to probe more deeply, you will have an opportunity to achieve above-average returns.
- You can improve your chances of achieving above-average returns by studying both fundamental and technical factors. Neither alone will suffice. (If forced to choose one, I would opt for technical analysis—this advice coming from a person who was employed for some years as a sell-side fundamental analyst.)
- Technical analysis works *because* it studies the results of buying and selling decisions by human participants in the marketplace. Human emotions and behavior can be understood; crowd behavior is reasonably predictable and readily measurable. Crowd behavior creates temporary price extremes that differ considerably from both fundamental value and emotional-equilibrium prices. Getting that part of the picture right is what pays you above-average money as either an investor or trader.
- Trading volume is a measure of the crowd's size and emotional temperature. Without a analysis of this factor, technical analysis is only half informed. Buying and selling are reflected in trading volume, and they are the cause of price change. *Price is the effect*, and its cause is trading activity. Therefore, study volume carefully.

You might not agree with all of the statements above. But if you are willing to investigate them, you will find the next couple of hundred pages stimulating and, I believe, profitable. If you believe in market efficiency

and price randomness and grant the alternative possibilities a fair hearing, perhaps you will discover some valid challenges to your assumptions by continuing ahead.

## PRICE: THE WRONG FOCUS FOR STUDY

Virtually the entire investment and trading world, willingly supported by the central subject concentration of the financial media, is focused on price. This fixation is quite understandable, but highly unfortunate. Price, of course, is a proxy for scorekeeping. We measure our net financial worth (at a metaphysical level, I would prefer to say *wealth*) by adding up what we own and subtracting what we owe. As an important component of that overall valuation process, we keep score of how we are faring in the investment arena by tallying up the securities we own. Much of what we own overall is measured only imprecisely. Even an appraiser could not accurately guarantee what your antiques and art would bring if sold. Blue-book pricing on your motor vehicles is approximate. It would be pointless to pay for frequent appraisals of your realty, and even those would be only expert estimates at best. But our stocks and bonds and mutual funds? Ah—here we have a wonderful and mathematically precise way of keeping score: Their prices are printed in newspapers daily and are available electronically at the beck of a mouse or a few keystrokes.

Watching the stock market has become nearly a national pastime and for perhaps too many a passion in recent years. Those who are in the market and those who are still thinking about it alike are fascinated by the constant movement of prices. As with the temperature and humidity, the racing form, and the latest sports scores and team standings, stock prices change every time we look. “The Dow Jones Industrial Average [or NASDAQ Composite Index] Jumped [or Dove] by 300 Points Today!” the TV reporters and newspaper headlines scream. Microsoft rose or fell \$3.25, IBM changed by almost \$8, and Genentech moved by over \$5. That hot IPO soared by 37 points in the first hour! We mentally multiply our holdings by the changes—and fret or celebrate.

Price tells the story since the price change multiplied by the shares owned equals the gain or loss. Price change is exciting. No change is a condition that is perhaps comforting to a wealthy retiree, but it is boring to most others. Price and price change get the headlines. When is the last time your local daily newspaper’s banner headline shouted “Market Unchanged”? We love watching the prices go up and down, like the rapid action of a close basketball game where the lead keeps changing hands. It’s exciting, and if the numbers move the way we want them to turn out,

we get richer *while* being entertained.

Volume? It's a footnote to the story on most days. Occasionally it's mentioned in the subheadline when the market has a historically wild session. It's just a fact mentioned in the text's fine print when an individual stock makes a violent move because millions of shares have changed hands on big news. Or it's a few digits in the stock tables tucked between the dividend and the real interesting stuff: the closing price quote and the day's or week's net change.

Here's a bulletin, just in: Price is not set by the stock exchange or by some hidden controlling cabal of super-rich market professionals. Price literally does not change at all if there is no trading. In fact, a stock not traded is omitted from the newspaper listings! Price is set by the balance or imbalance of buying and selling orders. Orders to buy and sell are the results of individual and professional investors' deciding to do something. If there are no perceived reasons to act, there will be no trading. If trading volume is zero, price is in suspension. *Trading causes all price changes.* Trading, which can be mathematically measured as the volume of shares that change hands, is the cause that sets the price. Price and its change are effects.

A novice sports fan or concert attendee enjoys the rewarding net result of the players' efforts. The horn concerto is beautiful and rich and moving; a baseball player makes a spectacular fielding play; a halfback speeds downfield for the winning touchdown. A sophisticated fan of performance relishes the replays even more: He or she learns how and why the musician achieved the tone we loved hearing; that the outfielder knew the batter's tendencies and shaded a few steps to one side of normal position; that a pulling guard made a key block that sprang the runner; that a swimming champion implemented a new training regimen and gained strength. The difference is all in the details. The first-level observer sees the results and either enjoys them or does not. Those with second-level perception appreciate *why* success or failure occurred.

The people who study price behavior in a vacuum are overlooking the all-important details that predict future price action. Those who vow to look behind the exciting result (price change) and study the cause (the amount of trading volume) have a deeper and more rewarding understanding. Understand the cause(s) intimately and you have a much better chance of predicting the effect.

Wall Street lore has it that Joseph Kennedy, father of the late president, got out of the stock market in the early months of 1929 and thereby preserved much of the family's wealth because of an astute observation. While making his daily and nightly rounds in New York's financial community and social circles, he noted that every average office and blue-

collar worker, even including the cabbies and bootblacks who served him, was in the market and had ready advice to offer others. Thus he concluded that there was no one left who had not already put their money into stocks; the rise therefore could not go on since all the available fuel had already been heaped on the fire. Unknowingly, Mr. Kennedy had discovered basic information that we now would call part of the added wisdom that behavioral finance brings to the study of market prices. He figured out that if the crowd has already done all it can or will do, prices are ready to move in the opposite direction because they literally can no longer maintain their recent trend. That golden nugget underlies the study of trading volume, which is why it should be an integral element of technical analysis.

Figure out what the majority is doing and you can discern in which direction price will move. Note accurately when the majority becomes an unruly crowd or mob, and you have pinpointed the time at which the effect of its more urgent activity (predominantly buying *or* selling) has reached maximum. Price movement is the net effect of changing balances between supply and demand. Trading is quantified and therefore measurable. Changes in trading volume imply changes in price direction.

## SOME HISTORY OF VOLUME

Many market observers can recite the Ibbotson data—exhaustive historical documentation of actual average annual returns of stocks since 1926—and they can recall when major market tops and bottoms occurred and when the Dow Jones Industrial Average first scaled a certain level. Who remembers anything about volume? Virtually no one keeps track of its history. For the record, and as context for today's tumultuous daily trading activity, Figure 1-1 provides a summary of volume levels on the New York Stock Exchange (NYSE).

Several points are worth observing from the data in Figure 1-1. First, trading has increased enormously. In January 2001, the NYSE recorded its first 2.3-billion share day on the news that the Federal Open Market Committee, the FOMC, had reversed course and reduced interest rates. That day's trade exceeded the average *weekly* volume in 1997, and nearly equaled the total volume of 1979! And, while the numbers shown are for the NYSE, NASDAQ reported trading has recently been running at about 150 to 200 percent of the Big Board trading volume most days. Beyond that, we know that considerable institutional trading in listed stocks takes place on the Instinet system and other venues. That fact—the diversion of orders from the NYSE floor—plus the rise in individuals' participation during the roaring bull market of 1998 to 1999, accounts for