Value Trading Basics

Introduction

At iTradePod we have a mantra –

*"Don't trade price, trade **Value**".*

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The 90% of unsuccessful traders will have no idea of this concept but the 10% who are successful will undoubtedly understand precisely what this means. Many unsuccessful traders also fail to fully understand what the markets they trade online actually are! When you trade from the comfort of your home or an office this may not be entirely apparent, but if you were standing in the trading pits this would be immediately clear. We are all engaged and interacting in an open auction market place. Once this is understood, you will then begin to see price only as an advertisement and focus your attention on looking for where value is.

What is value and how do we define it?
Value is a price zone or region that the market accepts as fair for the commodity, index, instrument or item that is being traded. This is the region where two sided trade takes place and buyers and sellers feel most comfortable facilitating trade.

Price Acceptance
Consider a baker who prepares 100 loaves of bread every day. He *offers* them at £1.50 per loaf. Every day he sells his entire 100 loaves inventory. Subsequently, the baker senses an opportunity to maximise profit due to the evident demand and, thus, increases his *asking* price to £1.75 per loaf. Again, the baker's entire inventory of 100 loaves all sell at the higher *asking* price. The market has **accepted** this higher price creating a higher fair value.

Price Rejection
It is important to note here that it is only because the buyer indeed accepted the baker's higher *asking* price by paying the higher asking pricing that an actual transaction occurs. An alternative scenario would have arisen if instead of accepting the baker's asking price of £1.75, the buyer put forward a bid of only £1.70 per loaf in which case a transaction would not occur until either the baker lowered his asking price and/or the buyer raised his bid so that the buyers bid price matched the baker's asking price. If the baker had to lower his asking price to attract buyers for any

transaction to occur then this would have indicated that those higher asking prices would have been viewed as being unfair by the buyers who **rejected** an attempt by the baker to sell his loaves at a higher value. In other words trade had not been facilitated.

Facilitating the Trade

Feeling extremely pleased with his business prowess he decides to probe the market further and increases his offer to £2.50 per loaf. At this higher premium price, over the following week he finds that on average only 10-20 loaves of bread are being sold per day leaving surplus inventory. At these new higher prices demand has diminished and the buyers have effectively rejected the value of this price increase. For two sided trade to take place the baker must reduce his *asking* price to where the buyers are happy to buy and facilitate trade. This from past evidence can occur at £1.75 where the baker expects buying demand to return offering *support* to his bread sales.

Auction Market Structure

This scenario is being acted out in every auction market, every day. Price is advertised looking for

where best two sided trade can take place. How, do we see this taking place in the futures markets? Firstly, the trader must establish where the value has been previously accepted (calculated from the previous day's activity). The high and low of this value area gives us the extremes of value. Any extension beyond these regions can present high probability trading opportunities depending on whether price is accepted or rejected. Our Trading Room clients are constantly reminded of the auction market nature of the market as they listen to the activity from the S&P 500 Pit Floor Traders provided by our Squawk Box partner.

Wisdom of the Crowd

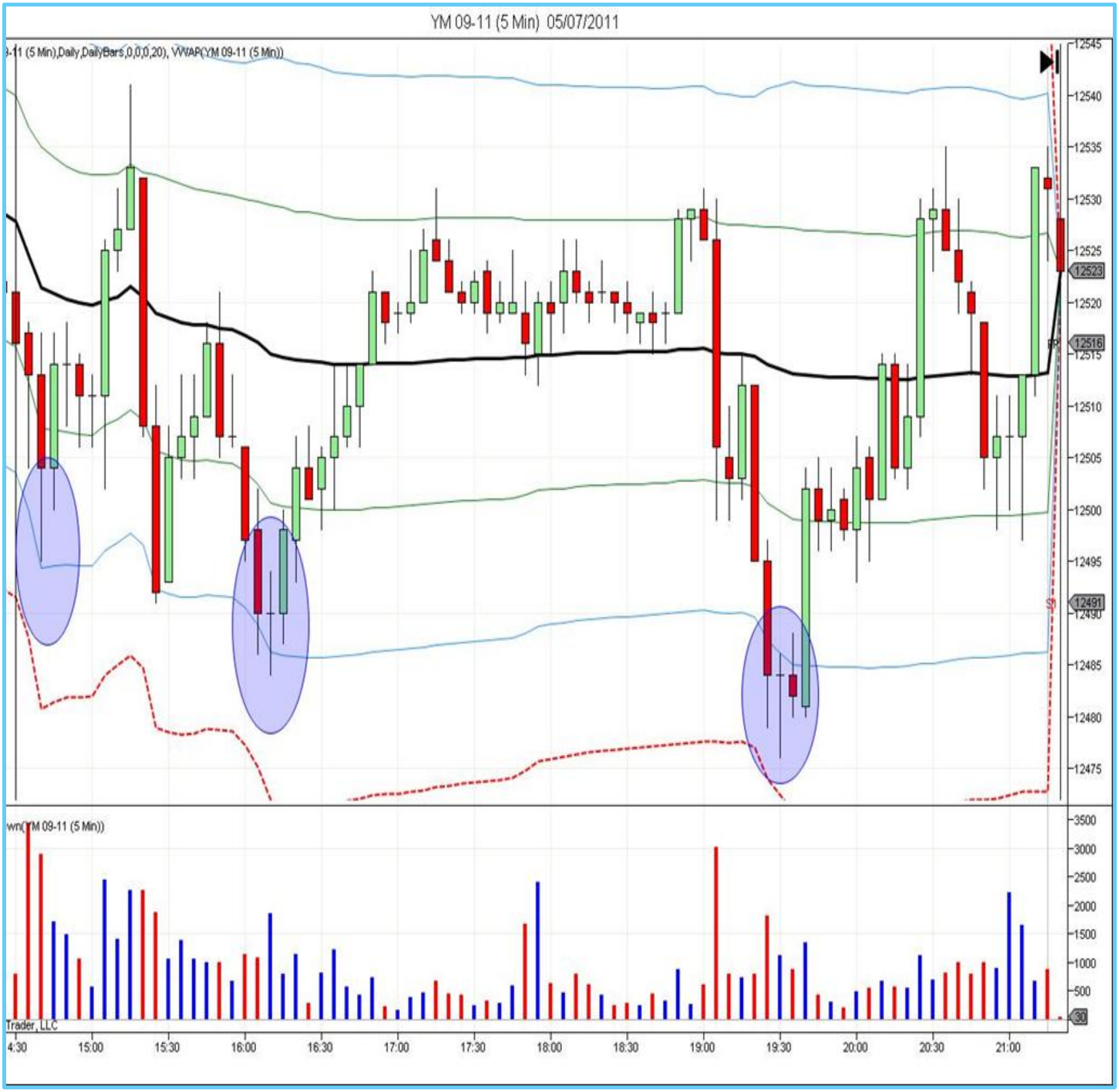
The wisdom of the crowd refers to the process of taking into account the collective opinion of a group of

individuals, (e.g. futures traders in the pit), rather than the opinion of an individual (e.g. a single trader sitting alone in his office) to draw a conclusion.

In **Fig 1** below, value was previously established (not shown) between 12, 482 and 12, 522. The day of July 5th 2011 was the second day of consolidation that was preceded by a five day bull rally. On July 5th 2011 we saw a market that had an Open Auction Out-of-Range (see the glossary on the iTradePod website for more info on the 5 different Market Profile® Trading opening types) type of open.

The thick black line near the centre of the price activity is the VWAP. The thin inner green and outer blue lines are the 1st and 2nd Standard Deviation lines, respectively. The outermost red dotted lines are the 3rd Standard Deviation lines.

Fig. 1 *07-05-11* *E-mini YM ($5) Futures 5 Min Chart* – NINJATRADER™



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Auction Market Development

In the [iTradePod Trading Room](), we use this potent combination of leading indicators together with our [Market Profile]()® and [Order Flow]() knowhow to give our clients an indication of how price is continuously ebbing and flowing (see **Fig. 2**) in relation to value, on an intraday basis. In fact, our [Trading Room]() clients have learned to consistently leverage this edge in a similar manner to how the remarkable '*The Wisdom of the Crowd*' method continues to yield a competitive edge for huge data collection corporations such as Google.

Our traders have developed a trading method that exploits our Financial Algorithms partner's Market Profile® style TPO Chart indicator that plots prior and unfolding value areas. Our algorithm specialists have also gone one stage further. They have developed an indicator that provides you with what is equivalent to a real-time value area in the form of the volume weighted average price and standard deviations from this average price. It is amazing to see how price respectfully fluctuates between these regions back and forth, day after day. Understanding how price interacts with the VWAP price and its standard deviations dramatically fine tune both entries and exits and gives our clients a professional edge. For example, knowing that the price rarely extends beyond the 3rd standard deviation presents high probability trading opportunities and an excellent trade location. In **Fig.1** the market structure that unfolded was neutral. Note how the price interacts and extends beyond the VWAP testing the 1st upper standard deviation. Typically the 1st upper standard deviation lines provide resistance with the lower standard deviation lines providing support. In the example shown in **Fig. 1**, the *Value Area Low (VAL)*, which coincided with the 2nd standard deviation line, formed strong support i.e. demand from buyers overcame the selling pressure.

Fig. 2 *Typical Auction Market Development*

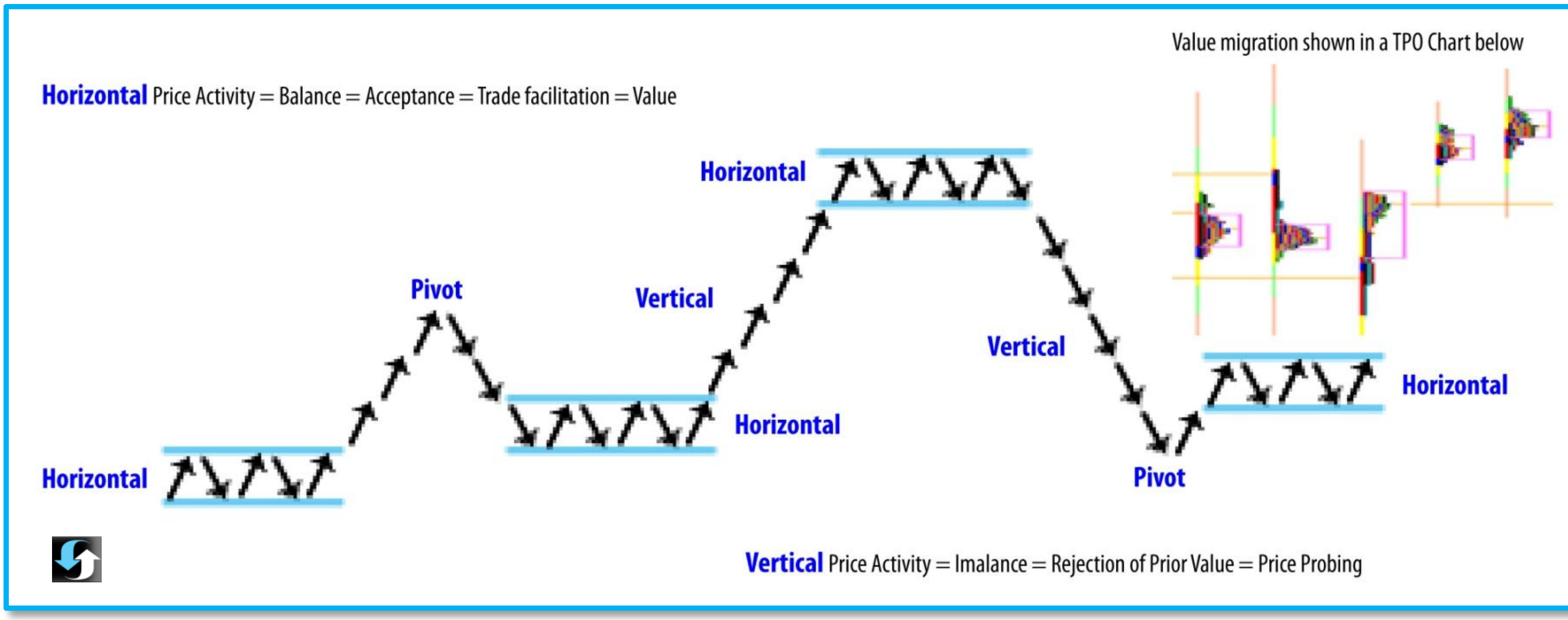

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Fig. 3 *07-12-11* *E-mini YM ($5) Futures 5 Min Chart*

Chart courtesy of our trading platform partner, NINJATRADER™

Fig. 3 shows a powerful reversal that occurred on the July 12th 2011. Observe how the bullish buyers moved price above the *VWAP* with a series of candles that had higher highs and higher lows. What unfolded was a classic bull trap. When amateurs were buying, believing this rally would never end, Trading Room clients were aware and alert to the fact that price were rapidly approaching the *3rd* upper *standard deviation*. This alerted our clients to anticipate a market pause or a possible opportunity to take a short. An additional heads-up was the Japanese Doji candlestick formation that formed at the peak of this upward move.

Further context on the day's market action would have been provided by a Market Profile® study (not shown) in that this upward move was actually a failed attempt to get through the point of control (POC) that was obviously rejected and resulted in lower value becoming established and accepted in the short term!

Next time I'll introduce you to how we use Market Profile® (Normal, Normal Variation, Non-Trend, Neutral, Double Distribution and Trend days), and Virgin POCs to go beyond short term analysis of intraday value migration.

About the Author

Rodney Lalgie is a professional futures trader at iTradePod and has over 10 years trading and investing experience. His current focus is in trading his own private capital using futures indices employing methods based on Auction Market Theory principles. He can be contacted on Twitter, emailed at **Rodney@iTradePod.com** or visit us online via the **iTradePod website**.