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Day Trader's DELIGHT: VOLATILITY

"In all affairs, it is a healthy thing now and then to hang a question mark on the things you have long taken for granted."

—Bertrand Russell

The S&P 500 finished 2008 with a loss of 38.5 percent, narrowly missing the dubious distinction as the widely watched benchmarks' worst annual loss ever by finishing just ahead of the 38.6 percent loss it suffered in 1937. Hardest hit were investors who experienced the bankruptcies of many companies

By Brian Shannon

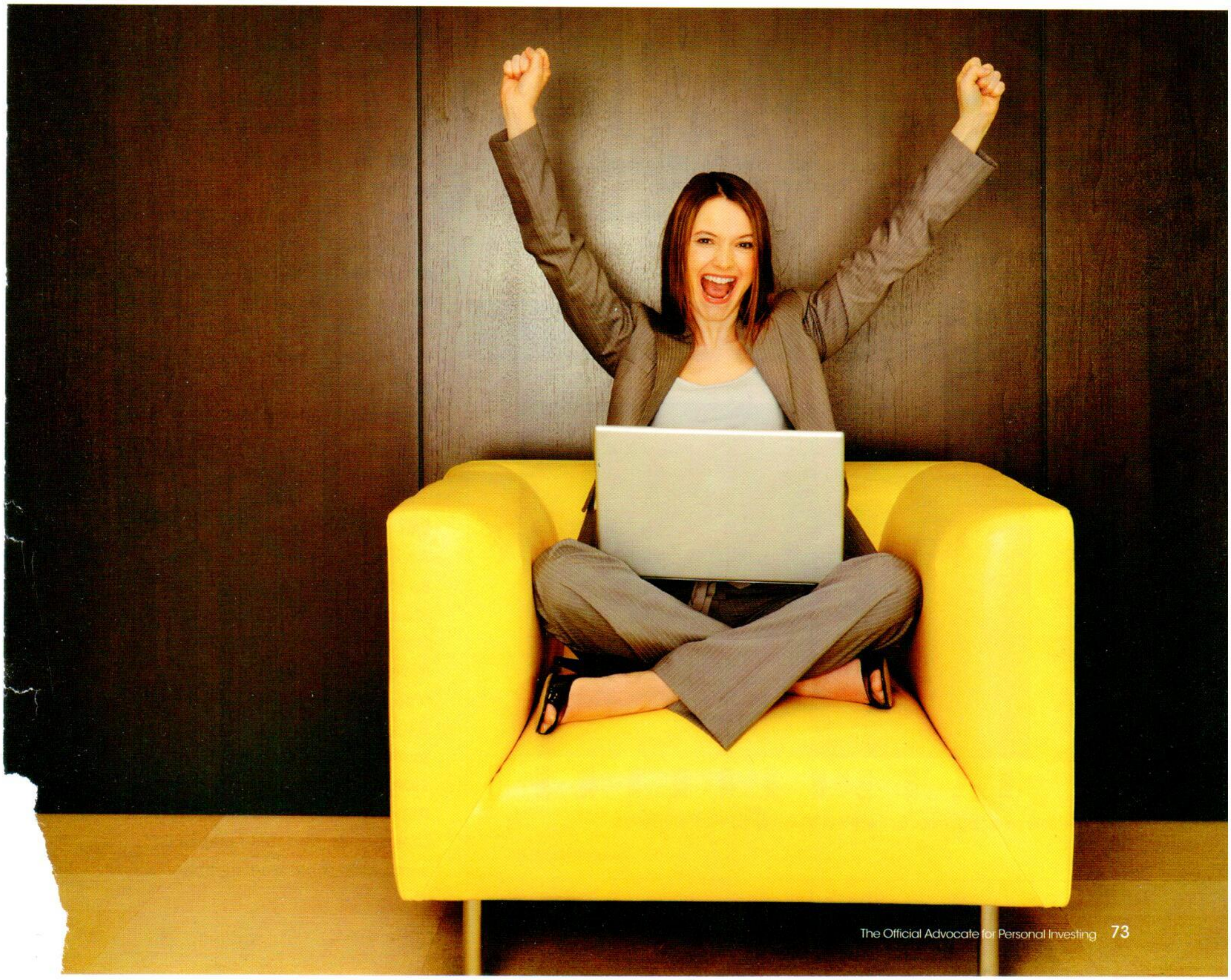
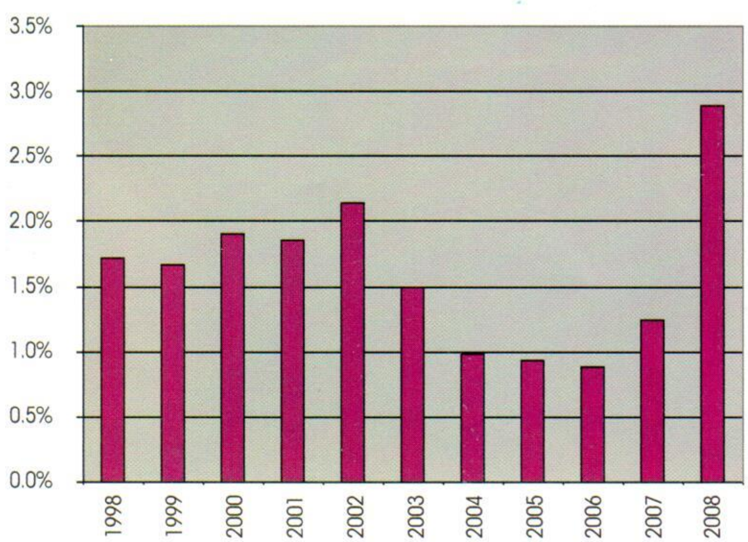


FIGURE 1: Long-term SPDR Trust Chart

The SPDR Trust chart of the previous 11 years makes a strong case for trading. The December 2008 close was below all but six of the past 120 months.

Source: Real Tick by Townsend Analytics

FIGURE 2: Average Daily Range of the S&P 500 Since 1998



The daily percentage range for the SPY in 2008 dwarfed the prior 10 years.

Source: AlphaTrends.net

whose stocks were once considered blue chips.

With the terrible financial damage done last year, the buy-and-hold school of thought has justifiably been the recipient of many questions. The long period of underperformance of equities as a general asset class, seen in Figure 1, has some of the most ardent investors taking a closer look at methods to better time their market exposure.

To me, it is clear that buy and hold is a flawed strategy, but maybe I am biased because I am a trader.

VOLATILITY: A LOOK BACK

Compare the volatility of 2008 to the prior decade, and the opportunity for traders becomes clearer. From 1998 through 2008, the average daily range of the S&P 500 (SPY) Index was 1.77 percent (see Figure 2). In 2008, the average daily range of the SPY was an amazing 2.89 percent, almost double the 11-year average and easily the most volatile during that time. The second most volatile year of the past 11 was in 2002, when the average daily range was 2.14 percent. Figure 3 breaks down the action of the SPY in 2008 into larger trends that were present throughout the year.

INTRADAY ACTION

An even more impressive volatility statistic is the average 30-minute range of the SPY during 2008 (see Figure 4). For each 30-minute period during the SPY's normal trading hours of 9:30 a.m. to 4 p.m. ET, the average percentage movement from the high to the low divided by the opening value was an impressive 0.78 percent! This type of volatility obviously makes for some incredible trading opportuni-

FIGURE 3: SPY Percentage Changes of 10 Percent or More in 2008

HIGH		LOW		NO. OF DAYS	POINTS	%	LOW		HIGH		NO. OF DAYS	POINTS	%
12/26/07	149.68	1/22/08	126.00	18	-23.68	-15.82%	1/22/08	126.00	2/1/08	139.61	9	13.61	10.80%
2/1/08	139.61	3/17/08	126.07	31	-13.54	-9.70%	3/17/08	126.07	5/19/08	144.30	44	18.23	14.46%
5/19/08	144.30	7/15/08	120.02	41	-24.28	-16.83%	7/15/08	120.02	8/11/08	131.51	20	11.49	9.57%
8/11/08	131.51	9/18/08	113.80	29	-17.71	-13.47%	9/18/08	113.80	9/19/08	128.00	2	14.20	12.48%
9/19/08	128.00	10/10/08	83.58	16	-44.42	-34.70%	10/10/08	83.58	10/14/08	105.53	3	21.95	26.26%
10/14/08	105.53	10/16/08	86.54	3	-18.99	-17.99%	10/16/08	86.54	10/20/08	99.10	3	12.56	14.51%
10/20/08	99.10	10/27/08	83.70	6	-15.40	-15.54%	10/27/08	83.70	11/4/08	100.86	7	17.16	20.50%
11/4/08	100.86	11/13/08	82.09	8	-18.77	-18.61%	11/13/08	82.09	11/14/08	92.06	2	9.97	12.15%
11/14/08	92.06	11/21/08	74.34	6	-17.72	-19.25%	11/21/08	74.34	11/28/08	90.13	4	15.79	21.24%
11/28/08	90.13	12/1/08	81.86	1	-8.27	-9.18%	12/1/08	81.86	12/8/08	92.38	5	10.52	12.85%
				TOTAL: -202.78							TOTAL: 145.48		

A closer look at the SPY in 2008 reveals there were at least 10 declines of more than 9 percent and 10 rallies of more than 9 percent. Obviously in a downtrend, the amount of points lost will be greater than the amount of points gained.

Source: AlphaTrends.net

ties. But as usual, with opportunity there is always the ever present risk to consider. My opinion is that risk management is job No. 1, and the primary way I manage risk is through timing based on some fairly simple technical analysis.

DOES T.A. HAVE ALL THE ANSWERS?

Technical analysis has been criticized by many of the largest and most highly regarded investors of our time. Peter Lynch once said, "Charts are great for predicting the past." With all due respect to Mr. Lynch, couldn't the same be said about a lot of traditional fundamental analysis? Don't earnings reports look backward? Or should investors just trust what the CEO's publicly say and invest with the faith that the information provided by the company is good and accurate? I am sure it would be easy to find shareholders in failed companies such as Washington Mutual, Bear Stearns, Fannie Mae, etc., who might not be so trustful now.

There is no way to predict the future, with technical analysis, fundamental analysis or any other method, humans simply cannot predict. I would never be so ignorant as to state that fundamental analysis merits no consideration, but truth lies in price action, not in words. I believe the real value of technical analysis is not in its predictive power, but that it allows traders to see objectively what people are doing with their money, rather than listening to words, which may not always be true.

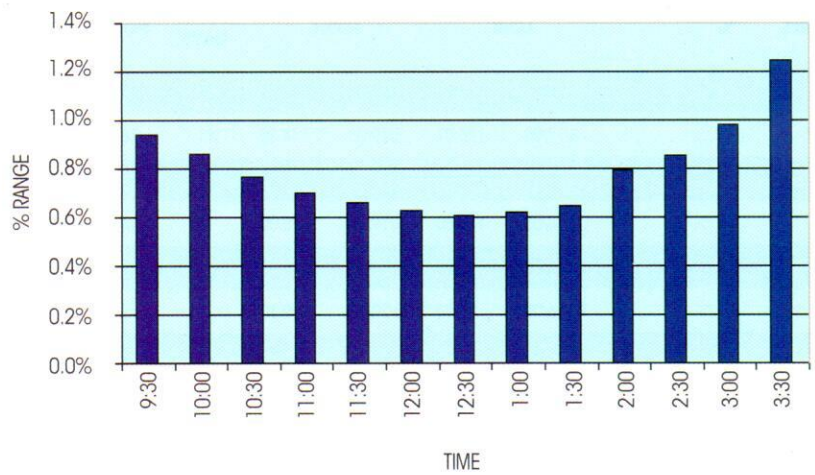
Understanding who is in control of the market (buyers or sellers) allows traders to position themselves to profit at the onset and the continuation of trends, and to exit when the momentum shifts. Of course, no one can get each trade right, but technical analysis allows traders to identify key levels of price movement to determine in advance what their course of action will be based on the only factor that pays: price! Perhaps the most value in technical analysis comes from traders' ability to determine the timing of exits so that when the market moves against them, they do not succumb to making costly emotional decisions.

DAY TRADING AND VWAP

With record volatility, I have found my trades becoming more day-trading oriented than at any other time in my trading career. The intraday opportunities are the best I have experienced in 16 years of firsthand observation. Along with record volatility (and probably the result of it), the macroeconomic backdrop has probably never been so uncertain.

These conditions create overnight risks larger than I am comfortable with, but it is a terrific day-trading environment. Of course, day trading is not for everyone, but if a person is going to be involved, one of the most valuable tools I use for intraday di-

FIGURE 4: S&P 500 30-minute Ranges in 2008



Intraday volatility for the SPY averaged 0.78 percent for each 30-minute timeframe of the day in 2008, creating ideal conditions for day trading.

Source: AlphaTrends.net

FIGURE 5: One-minute SPDR Trust Chart

The direction of the VWAP moving average (blue line) is an excellent reference point for directional control of a market.

Source: Real Tick by Townsend Analytics

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Another Article by Brian Shannon: **Increase Your Odds with Multiple Timeframe Analysis**, May 2006

rectional bias is the volume-weighted average price (VWAP).

HOW IT WORKS

VWAP is calculated by dividing the dollar volume of a stock by the share volume during a given period. Simply put, the VWAP is the average price at which each share was executed during the timeframe being studied. The VWAP is considered to be a fair benchmark for comparison of an institutional trade desk's ability to execute trades on behalf of its customers. If purchases for an institutional customer are made at a price less than VWAP, then the executing broker is considered to have done a good job for the customer. If the price paid was greater than the VWAP, the customer will be displeased and may shift lucrative commission business to a more competent brokerage firm.

This creates a very strong incentive for executing brokers to pay close attention to VWAP. Because institutions control most of the volume during the day and the competition for orders is so intense, many algorithmic trading systems are based around VWAP, which makes it an excellent tool to gain insight into these institutional activities.

I find VWAP analysis with a moving average—in particular for shorter term day trades on a one-day/one-minute chart of the ETF or equity I am trading—to be the most efficient way of determining who (buyers or sellers) is in control of trend for that session. Traders can think of VWAP as the moving target of value by the collective participants of the market being studied. Similar to a simple moving average, the daily VWAP is a number that changes as orders are transacted at varying prices throughout the day, the primary difference being that VWAP takes volume into consideration, not just time.

GETTING STARTED

Here are some guidelines (not rules) for analysis and trading with the VWAP. Traders generally want to trade in the direction of the VWAP. When the VWAP is advancing, it indicates that buyers have control of the momentum at that point and one's bias should be bullish. An increasing VWAP will often act as support for the stock as buyers attempt to purchase shares near the daily average and short sellers cover their losses. If price is below VWAP but the VWAP is rising, a good chance exists that the weakness is just a short-term setback and that buyers will be able to regain control.

A declining VWAP indicates that sellers are more aggressive than buyers, and a trader's bias should be bearish until VWAP shows signs of losing momentum. A declining VWAP will often act as resistance as sellers defend the average price and attempt to induce further selling from long holders whose confidence fades with price action. If price is higher than VWAP but VWAP is declining, there is a greater likelihood of the move failing to hold, and traders should be more defensive.

During periods of no trend, back-and-forth action should be monitored for break of range, which will often be in the direction of the next larger timeframe. When these periods of consolidation brake, it will often lead to a good trend-trading opportunity, particularly when coupled with a surge in volume.

USE DISCRETION

Like any analysis tool, the VWAP should not be confused with a trading system. The use of VWAP allows traders objectively to determine whether buyers or sellers have control of the market. The VWAP is an excellent tool to help form a trading directional bias. After that, the job is always to manage risk.

Brian Shannon is a full-time trader, educator and author of *Technical Analysis Using Multiple Timeframes*. He is also a senior contributor to StockTwits.com. Reach him at alphatrends@gmail.com.