High Volume Exposed:

Four Killer Scenarios Stock Traders Should Care About

By Soh Tiong Hum

The trading volume of each stock and the total volume transacted in the market can give a picture of its health and mood. When looked at in combination with price action, experienced traders can immediately tell whether a stock is ripe for action and how strong it is likely to be. This critical indicator is however often poorly understood by investors and traders. It is so important that it is included in the entry-level technical analysis course conducted by my company.

There are four killer scenarios in the stock market that can be detected when price and volume are inspected together. Investors and traders should remember that these scenarios can be found regularly and have high probability outcomes. Each scenario has specific characteristics and is easily recognizable. They can be used by savvy individuals to enter well-timed buys or avoid nasty sell-downs. I consider them so useful that I encourage you the reader to incorporate them into your trading rules.

These are the four scenarios:

PRICE RISES ▲ Trading volume increases significantly	PRICE RISES ▲ Trading volume falls
PRICE FALLS ▼ Trading volume is light	PRICE FALLS ▼ Trading volume increases significantly

Now before we go into each scenario, let's go through volume and try to understand it further.

VOLUME AND ITS ROLE IN STOCK BEHAVIOR

The stock market is a story of demand and supply. In such a story, there is the buyer, the seller and price.

In the stock market, buyers and sellers buy and sell share scrips based on their expectations of future prices. When buyers are enthusiastic, they are keen to buy at higher prices. Their action pushes price upwards. When sellers are enthusiastic, they are keen to sell at lower prices. Their action pushes prices down. Price is a consensus then between buyers and sellers.

Enter the picture with volume. In the market, company stock is a limited resource. Each company has a fixed number of scrips issued although the number differs between companies. For any company, the actual number of scrips in circulation differs due to two main reasons. Firstly, some companies have a larger issue. Secondly, scrips are usually held by long-term and short-term shareholders. Long-term shareholders hold a long term view of the company and do not usually trade their share holdings. Short-term shareholders actively trade their holdings because they do not look far over the horizon. They are often speculative in nature.

Therefore when we examine the trading volume of a particular company, we can tell certain stories:

1. Companies that have high trading volumes are attractive to speculators - traders anticipate ample price movement and expect to make short term profits.
2. Companies whose trading volumes expand suddenly deserve investigation because they may have reasons to attract short-term players.

FOR EVERY BUYER, THERE IS A SELLER

In every transaction, there is an equal amount of buying and selling. Price does not move up because there are more buyers than sellers. The right way to look at price movement is to understand which party is more motivated. When the buyer is initiating the movement, price moves up because buyers are keen to buy at a higher price while sellers are comfortable to stand aside. When the seller is initiating the movement, the aggressive selling pushes price down while buyers stand aside and not participating in any purchase. If buyers are willing to wait while sellers are keen to continue selling at a lower price, price will move downwards.

Now where does volume come in? I would like to share an illustration that is used in class to teach students who are new to the Price-Volume relationship. At Amoy Food Center, there is a wanton noodle stall on the second floor. It tastes good but is really well known for its value. A student visited the stall once after class came back and told us his count: for a $3 wanton noodle serving, there was char siew and a big bowl of soup that had a whopping eighteen pieces of wanton inside. Pardon me for deviating but this provides always a fun and excellent example during lessons.

Now imagine that there is a queue to buy from this stall with all its wholesome value. As long as the stall delivers excellent value, the queue lengthens. It is an encouragement to the hawker to raise price from $3 to $3.50 per bowl. In fact as wind of the excellent deal goes out, the queue might even get longer. This is a cue to the hawker (seller) that she is free to continue raising prices (stand aside to rising prices).

The stock market works in the same way. The wanton noodle queue is made up of motivated buyers. The length of the queue is similar to our trading volume.

Killer Scenario 1: Price rises, trading volume rises; rally is sustainable, 'let's join the queue too!'

Now as the hawker increases price further, the value offered to customers become diminished. In fact as the price continues to $7, $7.50, $8 and so on, even original fans do not want to buy. There is no longer any motivation to drive purchase. The queue shortens drastically. At some point, our favorite wanton noodle can no longer sell. The hawker contemplates lowering prices to attract buyers.

Killer Scenario 2: Price rises, trading volume diminishes; rally may not continue, 'better watch out'

Now I would like to use another example to illustrate Scenario Three. Let's recall the days of the bird flu scare. Folks were so afraid of eating fowl that hawkers of Hainanese chicken rice had to offer discounts. One stall offering cheap chicken led other stalls to offer discounts as well. Sellers were motivated to let go of their chicken before they spoilt in the fridge.

Just imagine if chicken rice that is normally sold at $3 per serving is sold now at $1. If one stall were doing it, it might be a novel idea and even seem a good bargain. If every stall were selling at $1, a thought will cross my mind "is that sick chicken"?

In this story, chicken rice hawkers are motivated sellers. All the stalls participating in the discount drive make up the selling queue or volume. Buyers are willing to forgo chicken (stand aside) so sellers have no choice but to push prices down further. We may not even know the reason why they are discounting but we better find out why.

Killer Scenario 3: Price drops, trading volume rises; 'find out why, don't catch a falling knife!'

Charts offer an excellent way to inspect Volume and Price

Illustrated with ShareInvestor Station

Well I don't have a good story to illustrate Scenario Four so let's just look at it this way. At some point, a stock in the market loses the trading interest of participants. Short-term buyers and sellers just do not have a good story to look at and do not expect great movements. In this situation, price could continue to fall at low volumes.

Killer Scenario 4: Price drops, trading volume falls; 'let's wait and see'

EASY RULES TO APPLY

Let me share now some tips on volume and how it can be useful to your investment or trading strategy.

1. Volume should be read in conjunction with price.
2. Volume can be found as a histogram in price charts; they are also published in the daily papers.
3. Use traded volume over 5 days to calculate daily average volume; this should give you a 5-day moving average of volume.
4. When the single-day trading volume of a stock exceeds its 5-day moving average by more than two times, the stock deserves further attention.
5. If you own a charting software that has a scanning function, tip number four can be a scanning criteria to find trading ideas for the next day. ■

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