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Trading With Equivolume

By Dick Arms
Special to RealMoney.com

Editor's Note: In this comprehensive column, Dick Arms explains how traders can use his charting method called Equivolume to increase profits. This column originally ran on RealMoney.com in late April, but we're offering it today as a special bonus to TheStreet.com *readers*.

If you're interested in learning more about Dick's trading techniques and finding out his market views and stock ideas each week, please click here for information about a free trial to RealMoney.

In the following pages, we'll look at some unique methods of analysis that can help make trading more successful and fun. In all examples, we're concerned with a holding time frame of days or a few weeks.

This methodology can apply to other time frames, but our emphasis will be on short-term trading. Our only aim is to buy at a lower price than we sell. We're striving for detached objectivity in the aggressive buying and selling of stocks.

This strategy is designed to swing the odds in our favor and help shield us from irrational emotional decisions. At its core, it combines price and volume into usable information. The interplay of price and volume will help tell us what others are doing and allow us to take advantage of that knowledge. There's so much information in the market that we need to concentrate on the few factors that can lead to extraordinary profits.

Not Your Typical TA Tool

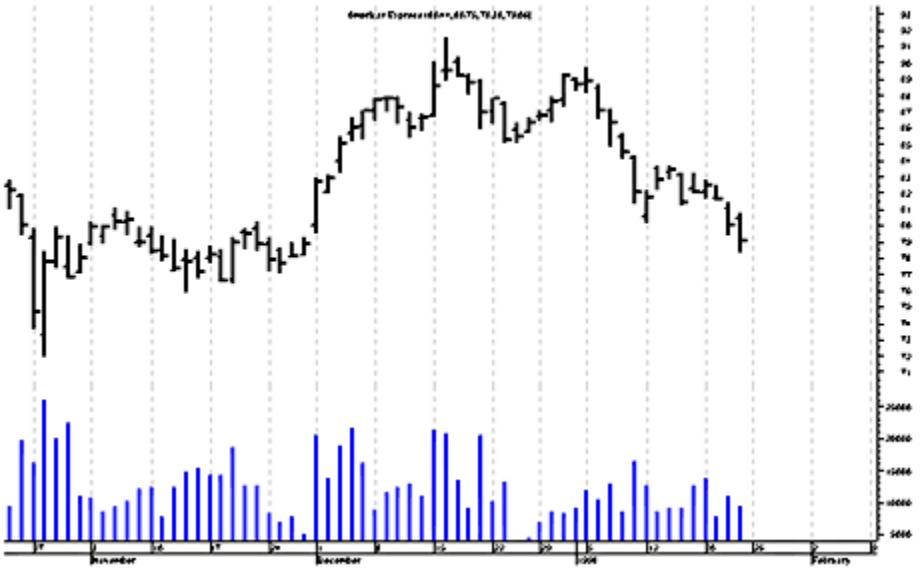
You won't see anything here about earnings, dividends, cash flows, management, sales or price-to-earnings ratios. We're concerned only about price and volume. This isn't because of laziness; it's because of our need to be realistic and objective.

The market determines a stock's price, and the trading volume represents the amount of interest in that determination. Fundamentals do not directly determine price; they're only as important as the emphasis placed on them by the millions of minds studying them. The market reflects exactly what the consensus really is. In the final analysis, the price of a stock and its volume illustrate a delicate balance between fear and greed.

The methods outlined here differ from other technical analysis methods because of the great dependence upon and emphasis of volume. It's of paramount importance, yet it's often ignored. Without knowing volume, you have no idea how much conviction is involved in a move. It's like buying a car without looking under the hood. Volume is the motor of the marketplace. To assess the power under the hood, we'll use my unique charting method called Equivolume.

Equivolume Charting

In the chart below, each vertical line represents one day of trading. The top of the line represents the day's high, and the bottom of the line represents the day's low. The little horizontal line is the level at which the stock closed on that day.



Source: Metastock

The bottom of the chart represents the volume. By tracing upward, we can equate the volume for each day with the price action on the same day, but it's difficult to know precisely which volume applies to which price in every case.

When I first thought of Equivolume as an alternative to bar charts, I was already aware of volume's importance. It was necessary to see whether volume was heavy or light as a stock moved through an old level of resistance or support. Volume tends to become heavy and price spread tends to shrink at important tops. Large price swings on heavy volume are typical of climactic bottoms. Volume is at the foundation of my Arms Index, and it bothered me that volume was often relegated to a secondary significance or even completely ignored. I felt volume needed to be made a full partner with price to understand the underlying dynamics of price movement.

When it came to me, it was absurdly simple: Combine the two pieces of information into a single posting. I moved volume off the chart's lower margin and incorporated it into the price posting. Each day would then appear as a rectangle, with the width being the volume.

The top of the box, as with a bar chart, would be the day's high, and the bottom of the box would be the day's low. I'd just be spreading each bar chart line sideways into a rectangle, as a function of the number of shares traded. The results were fantastic! Each posting started giving a much more complete picture of the trading -- a concise picture of supply and demand for that stock on that day. Shown below is an Equivolume chart of the same stock over the same period we were looking at above.

Source: Metastock

The first thing that becomes immediately apparent on this chart is that all days are not the same. Compare box "a" with box "b." Each represents a single day of trading, but one is tall and wide while the other is short and narrow.

Obviously, "a" was a very significant day, with a wide trading range and heavy volume. Box "b" was a far less meaningful day, as volume was light and there wasn't much price movement.

Box "h" is short but fairly wide, indicating volume but lack of price movement. It suggests the stock was encountering resistance after the light-volume rally.

Box "i" is tall, but on good volume, showing that the stock was moving downward with vigor.

One Chart, Many Stories

The shape and size of each box has a story to tell. Here's a closer look:

a. A heavy-volume reversal day. This looked like the culmination of the decline. Heavy volume and wide spreads are typical of the final washout of a drop.

b. A light-volume rally off the low. The lack of volume makes it far from convincing.

c. Here we are seeing a rally with better volume. It suggests that the low was tested, and the rally might carry further.

d. Notice the very light volume on this pullback. Now it looks like volume is coming in on the upside and drying up on the downside. That is a very bullish sign.

e. On the next day, volume explodes to the upside, penetrating the resistance we saw at "b" and saying the stock is headed higher.

f. After a big advance over the prior two weeks, volume remains heavy, but the range contracts. Perhaps the stock is encountering resistance after such a sudden rise.

g. This is ominous: heavy volume to the downside and a wide trading range. If we inserted a trend line along the bottoms of the rise, this drop would penetrate it. But the narrowness of the top suggests it's not likely to go lower until some attempt to rally is made.

h. The stock rallies, but the move lacks volume. It looks like a lighter-volume test of the heavy-volume top at "f."

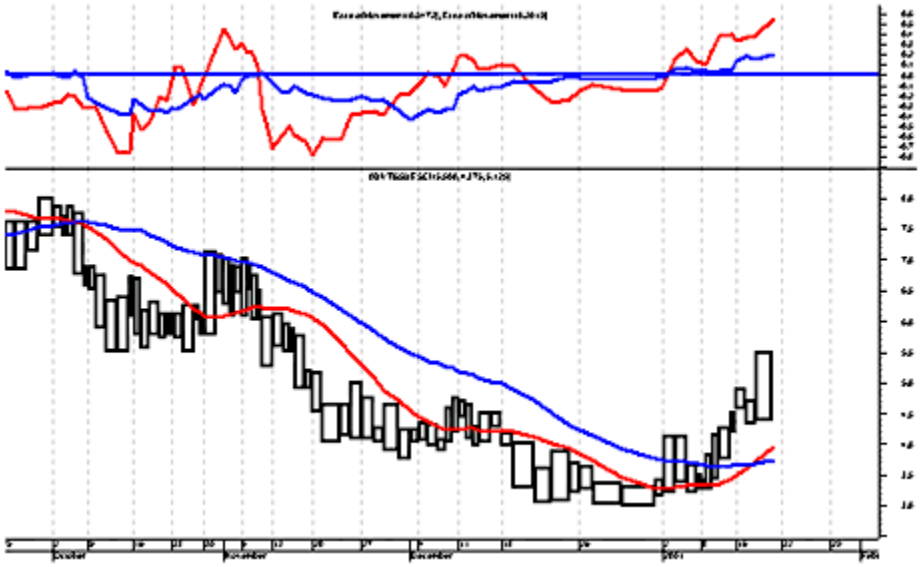
i. The decline resumes on heavier volume, and support is penetrated decisively.

j. The decline continues.

This is a fairly typical Equivolume chart, posted on a daily basis. By going to weekly postings or three-day postings, a longer-term outlook can be achieved. Very aggressive intraday traders might go to hourly charts or five-minute charts.

In any time frame, the signals given by the price-to-volume relationship are similar. On longer-term charts they tend to be more muted; on very short-term postings they tend to be more erratic. But the rules are the same. The shape and size of each box tell us how easy or hard it is for price to move in a given direction.

The chart below contains a number of other lines that need explanation. But first look at the boxes on this stock, as we did in the prior example. Notice the two boxes at the low; they are very wide and short, denoting extremely heavy volume in a narrow trading range and indicating a strong level of support.



Source: Metastock

The next two up boxes are tall for their width, but are still on fairly heavy volume. That signals the stock is turning up, and it's time to buy. Also notice the last posting on the chart. The stock has moved through an old area of resistance with increasing volume and a widening range. That's a very bullish signal. As we'll see a little later, a light-volume pullback is likely before going higher. Often, we look for that pullback before buying.

Superimposed are two lines, one red and the other blue. Those are moving average lines, but not the usual ones used on Wall Street. These are based on volume, not time. Heavier-volume days contribute

more to the moving average than light-volume days do. (Those interested in the further derivation of these volume-adjusted lines can read my book *Trading Without Fear*.) Note that the two lines tend to cross at or near important buy and sell points. Because they are volume-adjusted, they tend to be more sensitive to the heavy volume of tops and bottoms and give earlier signals than do the usual time-based moving averages.

Across the top of the chart is another pair of lines, representing two values for the Ease of Movement. Ease of Movement is a method of valuing each of the Equivolume boxes numerically, considering the size and shape of each box and the direction and extent of the daily price change. It's an attempt to ascertain whether it's easier for the stock to move up or down at any given time. As with the volume-adjusted moving averages, look at the crossover of the two lines as a clue to future price direction. A complete discussion of Ease of Movement is available in my book *Volume Cycles in the Stock Market*.

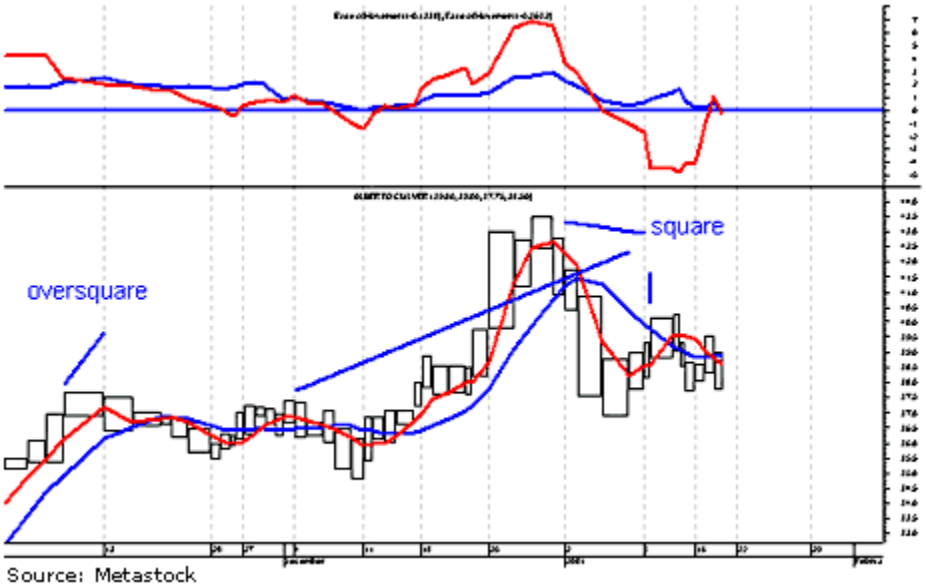
Tops and bottoms are not for buying or selling; they are for covering long or short positions. A possible top is an unconfirmed move, and trying to short a stock on that basis is too risky. But it is a time to take profit. Similarly, something that looks like a bottom is a good time to get out of a short position, but the risks are far too high to use it as a buy point.

Today we'll look first at Equivolume signals that suggest tops and bottoms, because they are usually the most obvious boxes on an Equivolume chart.

How to Spot Highs

When a stock gets to a top, it usually tells us so. Volume becomes heavy, and the price refuses to move. That produces an Equivolume box, or a series of Equivolume boxes, that is very wide for its height. You'll often see these boxes referred to as "oversquare" boxes.

(Note: To do my Equivolume charting, as in the charts that appear in this column, I use a charting program called MetaStock.)

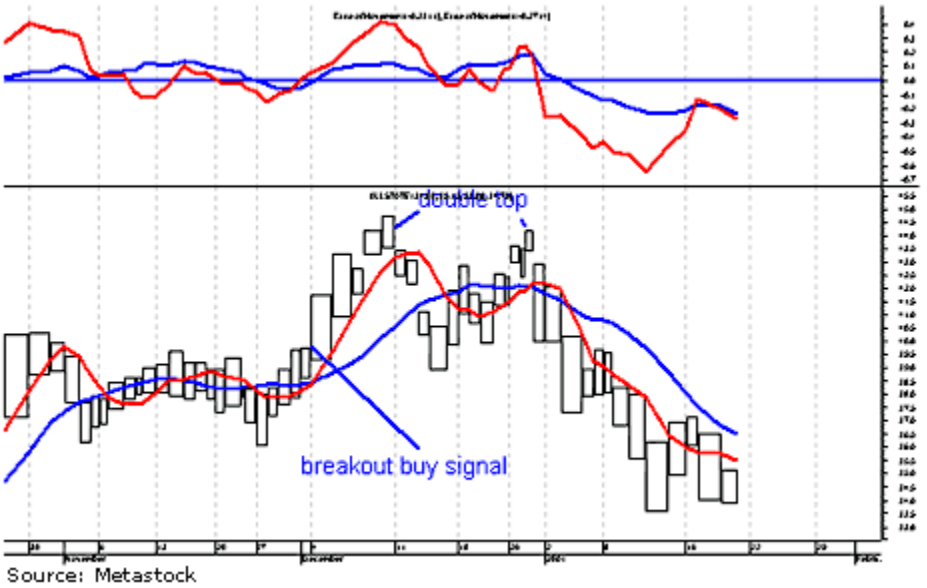


On the chart above, we see a number of instances in which the trading range became very tight while the volume became heavy. That produced the square and oversquare boxes. Why does this happen? After an

advance, there are still buyers trying to push the price higher. But they are encountering well-entrenched sellers who are willing to give them all the stock they want at a given price.

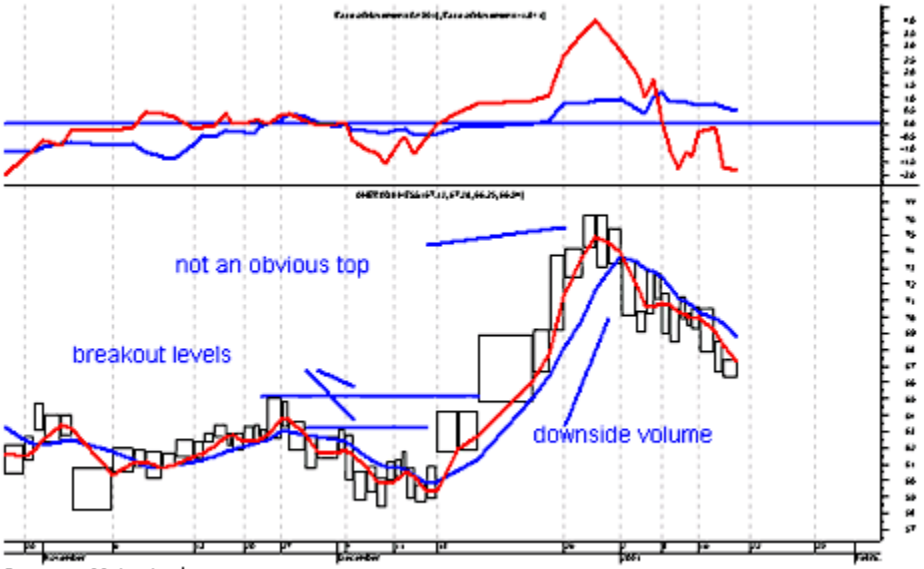
As the buyers push upward and the sellers resist, heavy volume is created, but the price acts like it has hit a brick wall. It's usually a clear sign of a top, and a warning that prices are likely to head lower. In trading stocks, we usually believe such a sign and are willing to take the profit. There are exceptions, obviously, but it holds true often enough to be heeded.

Often a stock will make a double-top or a triple-top before heading lower. For a longer-term investor, that's a signal to get out. Traders, however, aren't likely to wait that long. Typically, a triple-top shows up as a big square entry on the first top, and then diminishing volume on the subsequent tests of that top. A trader is well advised to get out on the first big square and take the profit. If it goes higher later, instead of forming a double or triple top, who cares?



On the chart above, we might have been buyers when the stock broke out above resistance. Just a few days later, at much higher prices, we started to see signs of resistance. That was the time to take profit. Later it did go back up to that level and formed a wide double-top, which then led to a very big decline. The stock told us very early that it was running into resistance and should be sold.

Unfortunately, stocks don't always act exactly as we expect. Sometimes the topping action will be far less obvious.

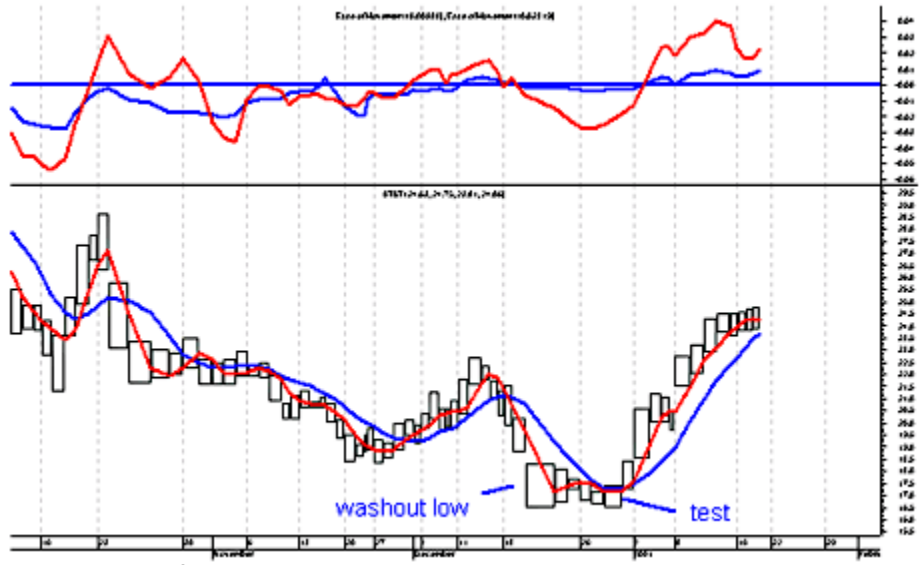


Source: Metastock

The breakout was obvious in the stock above, and the subsequent move was very gratifying. But when it reached the top, it did not tell us so. The range did contract, but the volume was not excessive. Only a couple of days later did trouble become apparent. The clue was the heavy downside volume with a wide trading range. The ascending trend was broken, and it looked like the stock was headed lower. On atypical tops, we need to watch for other clues.

How to Spot Lows

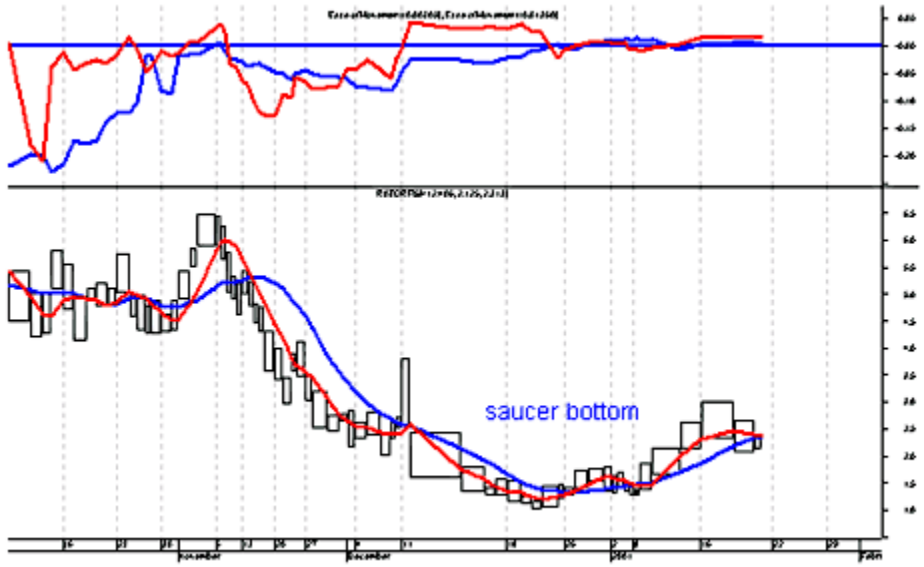
Lows tend to be different than highs. They are more emotional. Fearful selling often results in climactic action, in which volume becomes very heavy and the trading range is wide. Therefore, we're more likely to see very large Equivolume boxes on bottoms, but they are less likely to be square or oversquare. The typical bottom consists of a big box that washes out the sellers, followed by an immediate rally, and then a lighter-volume pullback that tests the old support.



Source: Metastock

On the above chart, the stock had been in a long decline. Finally, it gapped down on huge volume and seemed to get rid of the last sellers. That was followed by a weak rally, then a return to the low, before a believable rally could get underway.

Often, though, we'll see lows that look more like tops: a series of heavy-volume days with a very tight trading range. Instead of a panic selloff, the decline ends with a gradual shifting from weakness to strength. When that happens, a rounded bottom develops, which we often call a saucer bottom. This sort of low can be very profitable. It forms a wide base and therefore is likely to lead to a substantial advance. The chart that follows pictures a typical saucer bottom. Notice also on this chart the impressive upside volume as it emerges from the saucer.

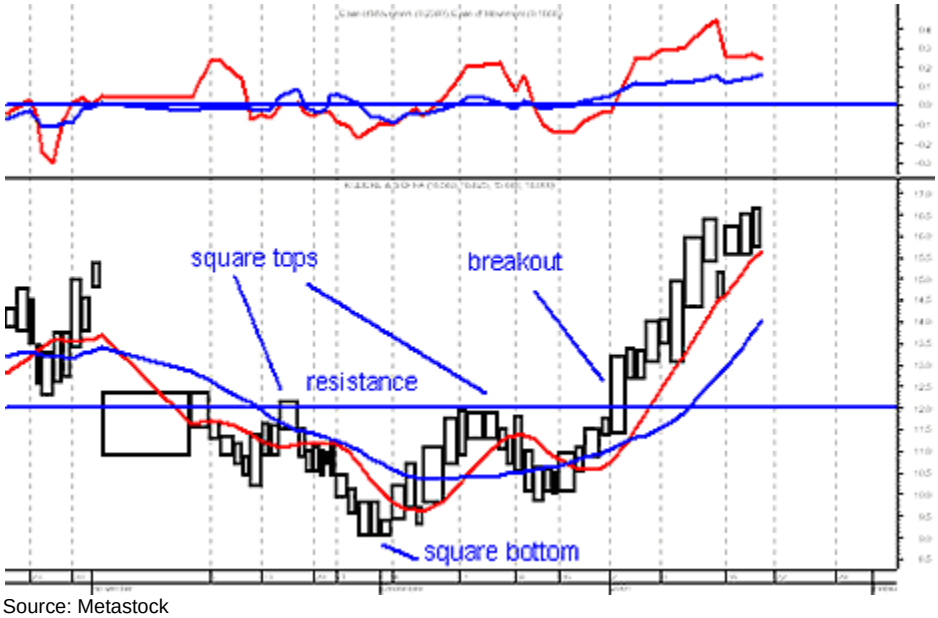


Source: Metastock

That upside volume out of the base would be a strong signal to cover short positions, and even to go long.

Breaking Out With Power Boxes

The classic technical picture I like using is a stock that has had a long decline, given signs of a bottom, built a substantial base, then sent a signal of strength. All of these earmarks are exhibited in both price movement and volume characteristics.



Source: Metastock

The first notation on this chart is the square top we saw as it tried to rally after a long decline. The heavy volume and lack of progress suggested that it was encountering formidable overhead supply and couldn't get through it. Then it dropped to a level where we saw the same sort of square entries, but now on the downside.

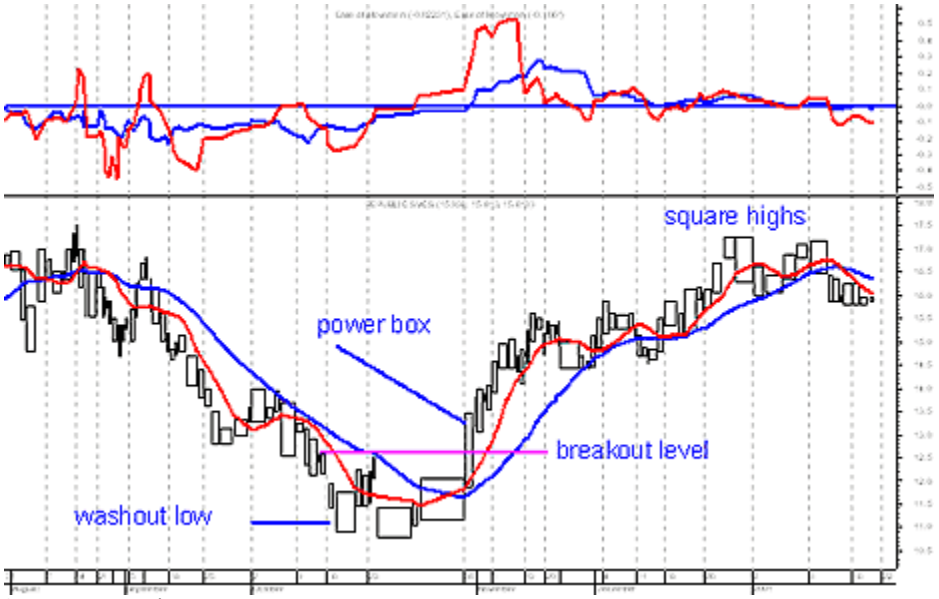
The next rally was more encouraging, because, for the first time in months, volume was coming in as the stock went up instead of becoming heavier as the stock went down. But when it got back to the old resistance, it stalled again and made another series of square tops. The sellers were still there and wouldn't let it through the barrier. It pulled back again, but not so far, and volume was lighter. We were still in a base area, but it was becoming more encouraging.

Then, on the next rally, it broke out! Notice the box it made on the breakout: a tall box showing that it was moving well, but heavy volume showing power. The stock appeared to be on its way.

The breakout box is what I like to call a "power box" -- one with height and width. A tall, thin box that lacks volume as the stock penetrates resistance is suspect. A short and wide box through resistance is equally suspect, because there are obviously many big sellers just above the old resistance level.

But a tall box that also has width indicates a very strong situation. There are many aggressive buyers, and the sellers are toppling before them. That's the sort of breakout box we saw in the stock above, and those are the situations we should be searching for.

Here's another power box breakout:

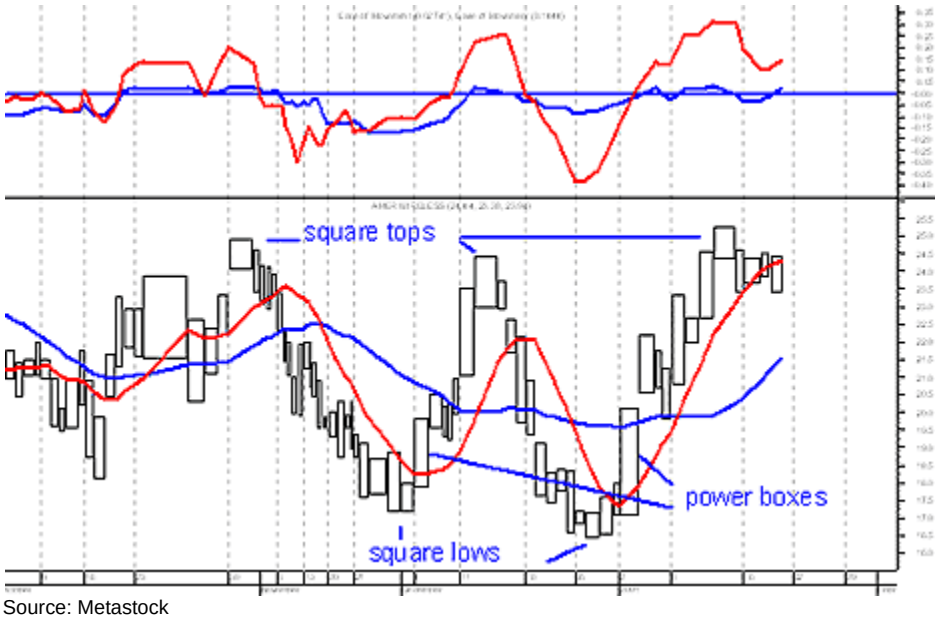


Source: Metastock

After a long decline, the stock gapped down. A day later, it traded on very heavy volume in a fairly wide trading range. That had the look of a bottom starting to form. Next it rallied on very light trading before dropping back to the old support area on enormous volume, creating an oversquare day. After two more days in the same bottoming area, it moved sharply higher. It was a tall box with good volume, suggesting the stock had made a legitimate turn.

Moreover, it went through the level where it had been turned back on the prior rally, making it look like a breakout from a base. In the next few weeks, the stock went up about 35% before encountering heavy resistance. Finally, we see the square Equivolume entries on the highs. That was a strong hint that the advance was ending.

Below is a final example of power boxes to the upside. Also notice the typical square entries on both the highs and the lows of each cycle.

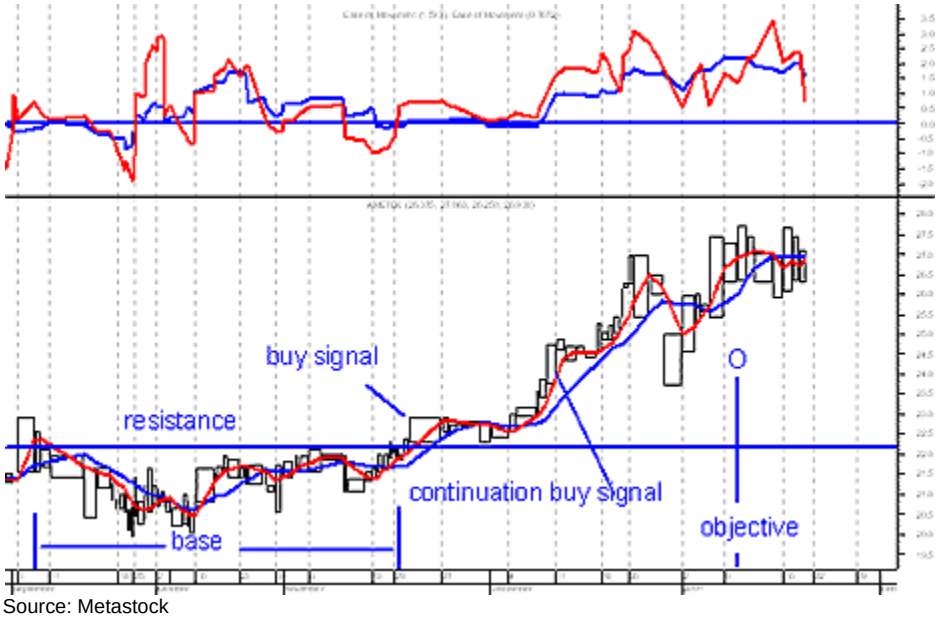


Source: Metastock

Buying Continuation Patterns

My other favorite buying signal is a continuation of an earlier breakout. As with the breakout, we want to see heavy upside volume through an old level of resistance. Moreover, we want to be sure the stock has the right volume characteristics, i.e., it's getting heavier volume on advances than on declines. Third, it needs to have the potential to move a good deal further.

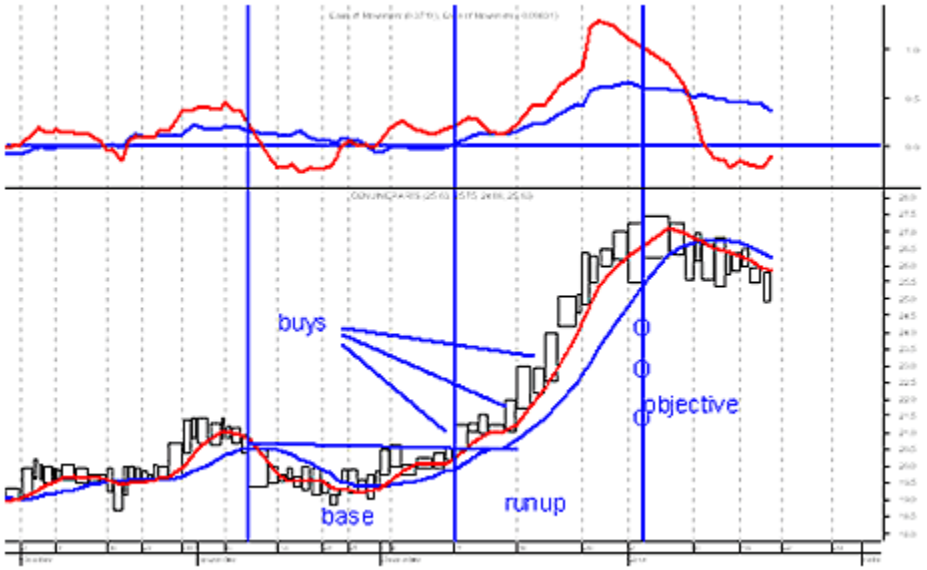
The stock must have enough base to suggest that the advance isn't over yet and that the objective is at a higher level. Understand that the width of the base is usually very nearly the same as the width of the ensuing advance. Similarly, the width of a top is about the same as the width of the decline that follows.



Source: Metastock

This stock built a very wide base lasting about three months. The base is the distance between the two vertical lines. It gave a buy signal as it came out of that base. Volume was much heavier as it penetrated the resistance. After moving sideways and then higher, it again had an upside power box a month later. I show that as the continuation buy signal. The two vertical lines show the width of the base.

Because this is an Equivolume chart, we're really measuring an amount of volume, not time. I have measured sideways a distance equal to the base and marked it as the objective. Because the second indication to buy came well short of that objective, it was a believable signal. The high came in roughly where it had been forecast.



Source: Metastock

Here's another example of multiple buy opportunities. Each time the stock ran through a resistance level, volume expanded. Each time it pulled back, volume contracted. The wide base justified a long advance. The stock finally encountered resistance and went square, suggesting the move was over. Obviously, all stocks don't always behave so well. Therefore it's important to always have a stop order, or at least an idea what sort of action would say that a bad decision had been made.

Every buy suggestion on my Web site is derived by looking for either a new breakout or a continuation pattern. Within the time frame we are using, they are the only formations that carry big odds of being correct.

For example, in a longer-term decline, there are often countertrend rallies, but they are usually on light volume and short-lived. Because the longer-term trend is down, the risks are too large to be buying such a formation. Thinking a stock has finished going down is not reason enough to buy, either. The stock could have stopped going down but not be ready to go up, meaning money might remain idle while waiting for the move to develop.

The reason for buying a stock is to participate in an upward move. The best time to buy is when others have just started to buy it. Big buying shows itself in heavy volume and a wide trading range -- a power box on the Equivolume chart.

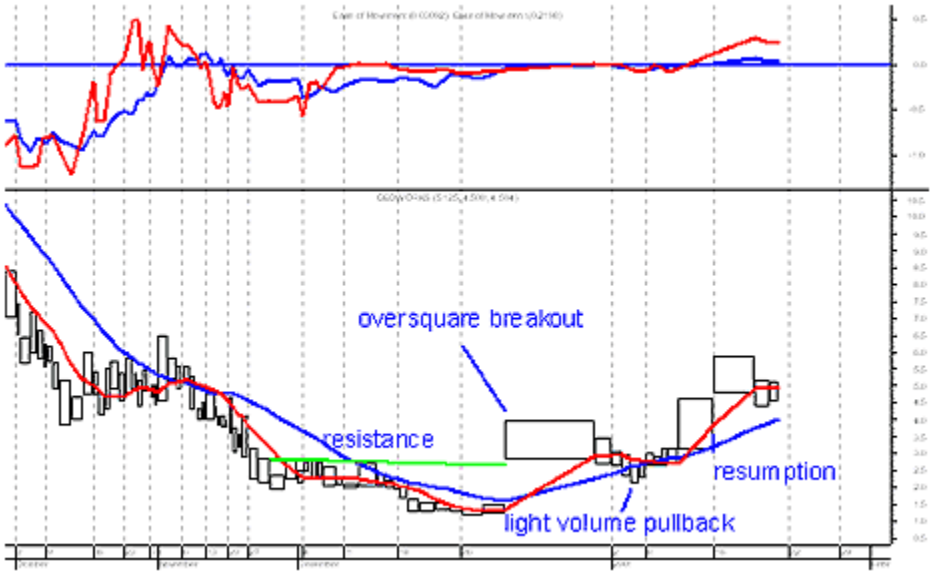
We don't ever want to be contrarians. We want to agree with others, but only very early in the move. The big-volume move is usually caused by professional money coming in. Later in the advance, the amateurs are buying. We want to be on the pros' side.

The Exception

We do use one variation on this strategy, however. In some markets, and in some instances, a power box is followed by a light-volume pullback. That pullback is likely to return the price to somewhere near the breakout level.

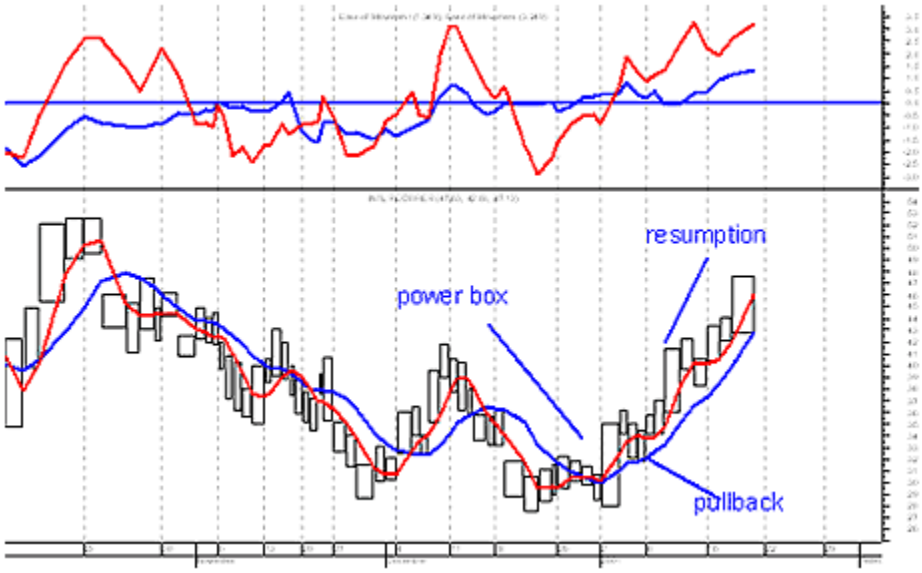
In a fast-running stock or a greatly oversold market, sometimes we don't see many such pullbacks. At other times, they are quite common. They can often give us the opportunity to buy at a somewhat better level. Depending on the stock and the way it's acting, we sometimes will suggest waiting for a pullback to buy. At other times, where it is less clear, we suggest taking a partial position on the breakout, another partial on the pullback and a third piece when the rally resumes.

On the chart that follows, we see a case in which the breakout, while dynamic, was worrisome because it was so oversquare. It said the move was already encountering resistance. Therefore, you might be inclined to wait and see if it would pull back before going higher. It's especially important to be sure that volume dries up on the pullback. It says that the sellers are running out of energy. The resumption of the advance should be accompanied by an increase in volume, as in the example. Big buyers are back in, and it looks like they'll run the stock higher.



Source: Metastock

Here is another example, in which we see a typical lighter-volume pullback before the advance resumes.

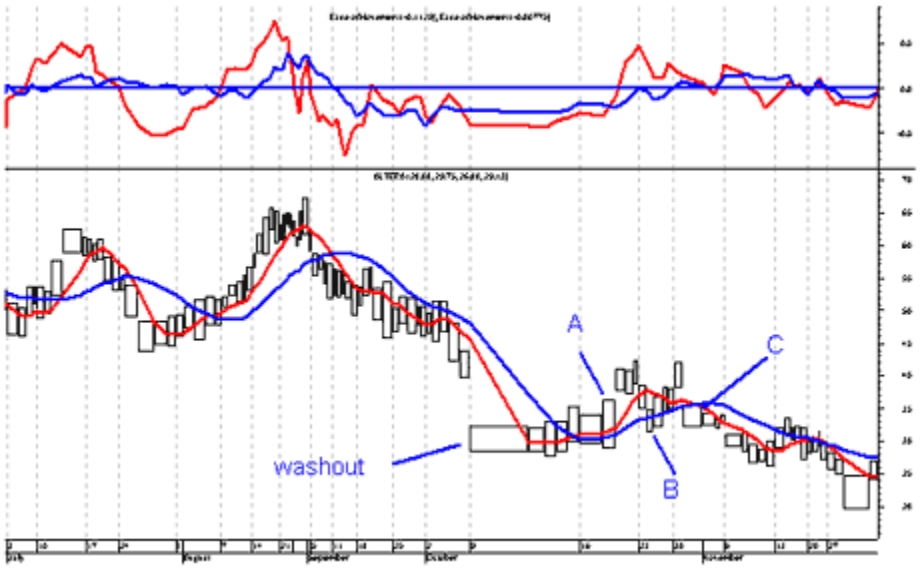


Source: Metastock

Before Entering, Locate the Exit

Before buying a stock, traders need to decide where they want to get out. You should plan for two different situations: selling to take profit and selling to correct a mistake. As time passes and the position moves, you'll need to re-evaluate and adjust those decisions. Each position should be revisited at least daily to ensure the situation hasn't changed.

First let's look at when to get out if we're wrong, which is inevitable. Staying with a bad position can be disastrous. As soon as the stock looks like it won't act as expected, the position should be closed out. That means either having a stop order entered that will take out the position automatically, or having the discipline to admit a mistake. Let's look at an example.



Source: Metastock

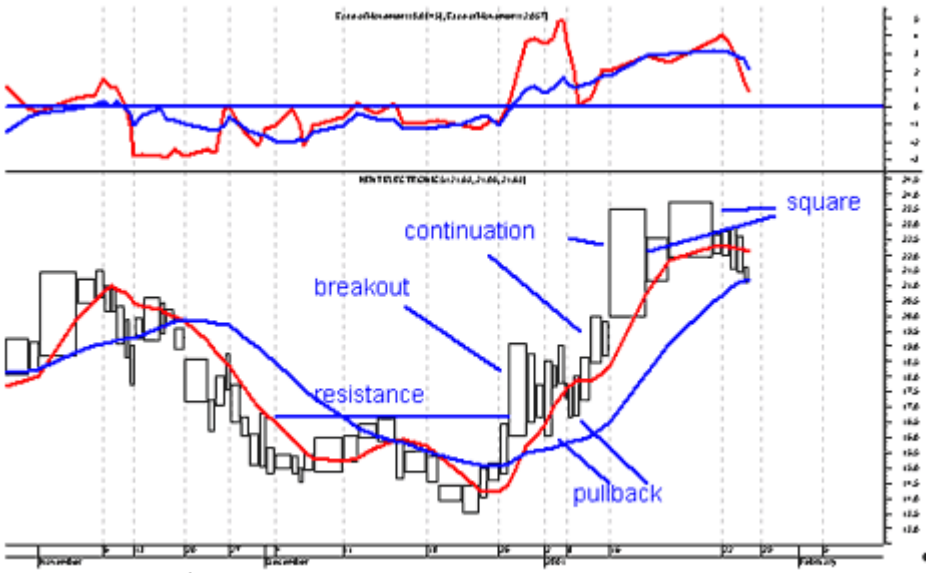
The stock pictured above looked like a very promising buy. After a long decline, there was a heavy-volume washout, with an oversquare entry. After some base-building, there was a sign of strength at "A" that looked like a time to buy. The pullback to "B" was on lighter volume, suggesting the position was valid.

But the next rally was bothersome. It lacked volume and could not penetrate the earlier high. At "C," volume became very large as it dropped. This was unexpected and suggested the stock was not acting right. A nimble trader might have thrown in the towel there. If not, there should have been a stop order below the prior low at "B." It would have been executed a few days later. Either way, the stock told us that it wasn't acting as expected.

That, rather than a percentage rule, should be the criterion for covering a position. In fact, in taking a loss or in any covering of a position, it should be based on the observation that the move is no longer acting well.

After a stock has moved up and is showing a profit, a stop should still be used as a discipline for getting out if the stock starts to do the unexpected. We saw above that a clue to the end of a move is an oversquare day. That could be considered another case of "not acting right." If a stock acts as we expect, we should stay with the position. But as soon as it acts wrong, it should be gone.

Notice in the chart below how the stock acted after the strong advance out of the base. It looked like it had penetrated another resistance area and was likely to move higher. But then it backed off with a somewhat square entry, which is worrisome.



Source: Metastock

The next day it tried to resume the advance but was unable to, even though volume is immense. The result is a very square Equivolume entry. Something has changed and the unexpected has come to our attention. It appears to be time to get out. Besides, the width of the advance is about the same as the width of the base, so our objective has been satisfied.

Knowing when to sell is not easy. A buy can be unemotional, but once a decision has been made to buy, people are reluctant to admit being wrong and want to take a profit to prove being right. That leads to less objective decisions.

I've found I have to force myself to sell "too soon." When I own a stock and it has moved with me, I get to like it. That allows me to make excuses for it. Abandoning a winner is like kissing off a friend.

There's a tendency to give a winner more leeway than a loser, but that's a mistake. Just because a stock has gone up 10 points after you bought it, that isn't a reason for letting it drop 5 points without selling it. I've had to learn to grit my teeth and abandon my friends as soon as they disappoint me.

Selling Short

Aggressive traders should be as willing to go short as they are to go long. There are two sides to the market, and they might as well both be used. It's argued that the short side is more dangerous because there is no limit to losses. That's true, but a trader should never stick around long enough to discover that. As soon as a position starts acting wrong, the short should be covered.

In a way, the short side is safer for a trader because most up moves take twice as long as down moves. Therefore, if you are long, the position goes with you slowly but against you quickly. Conversely, if you are short, the position goes with you rapidly but against you slowly. You're likely to have more time to correct mistakes.

In shorting a stock using the Equivolume methodology, the principles are similar but inverted. In buying a stock, we want to see a decline, followed by a base-building period, then a sign of strength. If we're selling a stock short, we want to see an advance, then a sideways consolidation and then a sign of weakness.

Just as we did not want to buy just because a stock appeared to be done going down, we don't want to be short-sellers simply because it appears to have stopped going up. Every trend has a better chance of continuing than it does of reversing. If we sell it because it appears to be done going up, we're fighting the odds. It's about a 2-to-1 chance that the consolidation will be followed by a resumption of the advance rather than a break to the downside. So before selling, we must have information that tells us the trend has reversed.

A sign of a top, such as a large oversquare box, is a very good reason to take a profit on a long position, but not a reason to sell short. The stock could languish for a long time in the sideways area, so the money would be inactive.

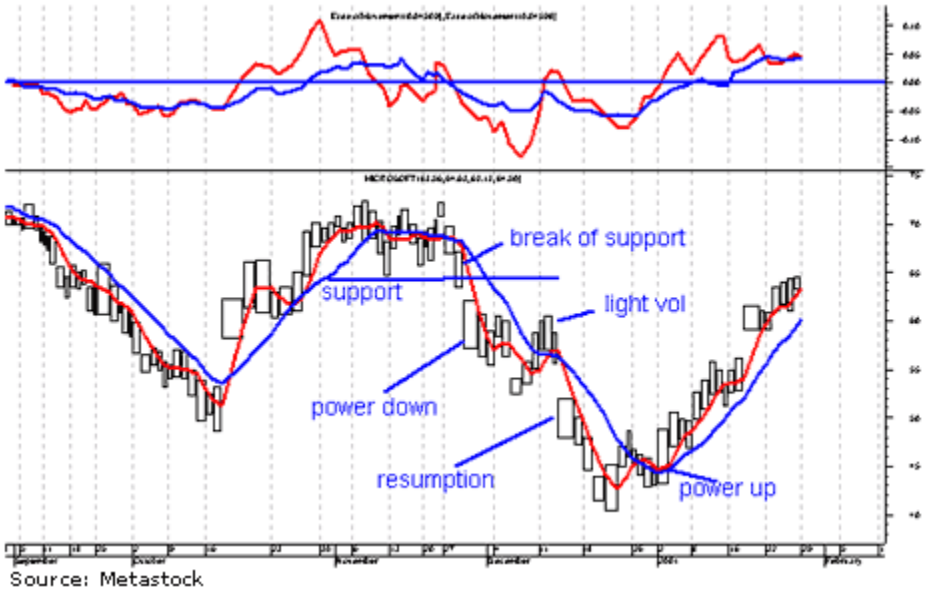
Source: Metastock

Here's a good example of a successful short position. In the early part of the chart, we see the last part of an advance. The start of the top-building process isn't easily noticed.

But then it makes a second top at the same level and backs off to the support zone. There's still no reason to sell this stock until we get the power box to the downside. That's a definite breakdown and a strong suggestion that the stock will go lower. We might wait for a light-volume rally to the breakdown level, but in this case, it never occurs.

The subsequent drop is rapid and large, culminating with an oversquare Equivolume entry. That is definitely a signal to cover the short position and take the profit. It is not a signal to go long. Perhaps you end up buying later at a higher price, but by then you've built a base and had a sign of strength.

The chart below of **Microsoft** (MSFT:Nasdaq - commentary - research) gives us another good short-sale example. Shares had a fast advance in October, which then turned into a sideways consolidation.



The early-November pullback established a support level for us to watch. That support was broken with a big trading range, although the volume was not particularly heavy. But it gapped lower the next day, and both volume and range expanded, producing a power box to the downside. It certainly confirmed the sign of weakness we had seen the day before.

After slumping further the next week, it rallied, but on poor volume, suggesting the decline had further to go. The decline did resume, with another gap down and another power box to the downside. The stock fell, from the first sell signal to its low point, around 30% in about a month. Notice also that the next power box to the upside penetrates resistance and takes the stock right to the level it was before the short sale.

Support and Resistance

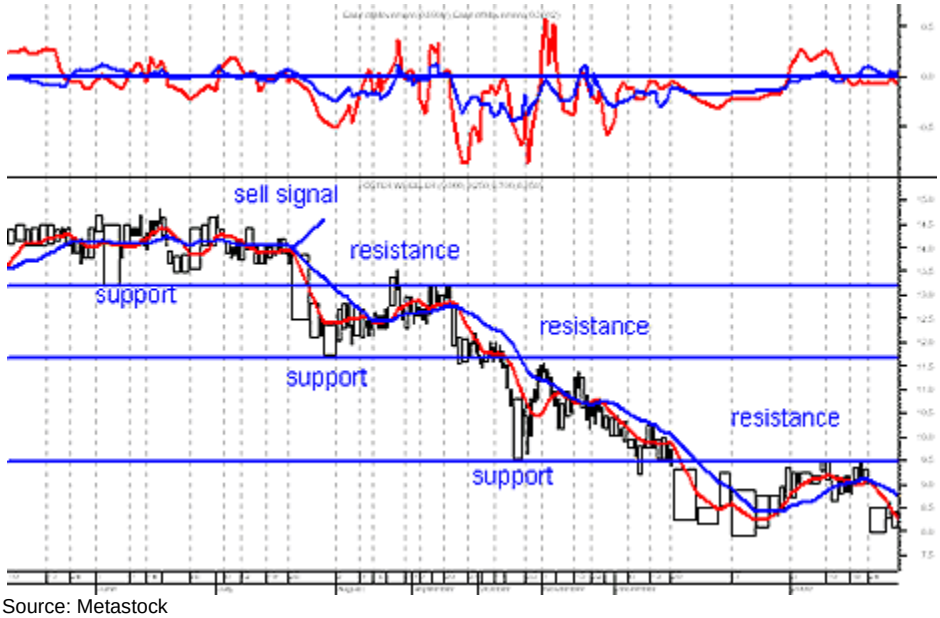
As a stock moves higher, it runs into levels that repeatedly turn it back. Often after that resistance level is surmounted, the same level serves as support on declines. If a long position moves higher, as expected, and reaches an old resistance level, it must be watched very carefully.

Equivolume can often be extremely helpful here, because we want to know where the price is and how hard it's working to move. The box shapes are often a clue. Square Equivolume entries at the old level are enough of a warning to justify taking profits.

Source: Metastock

On the chart above, we see action that's quite typical. Across the center of the chart, I've inserted a horizontal line. Early in the period shown, it served as resistance to upside progress. Later the stock moved up through that level, and subsequent declines stopped at the same level. So the old level of resistance had become a new level of support.

After the stock moved back down below that line, it again acted as resistance on the right side of the chart. In addition, a lower level of support has tended to hold the stock up repeatedly. It was penetrated at the right side of the chart, but briefly, and in a manner we should have recognized as being climactic.



Source: Metastock

The stock in the above chart gave a very prominent sell signal. A strong support level was broken with increasing volume and a widening range -- a power box to the downside. After that, it had a long decline that consisted of a number of stairsteps down. It found support at a level, then rallied from that level to the prior support level that had become resistance. Each drop was on increasing volume, and each rally was on decreasing volume, and this says that the decline had further to go.

Way to the right of the chart, though, volume became very heavy, and the range tightened up, thereby producing square Equivolume entries. It was an easily discernible signal to take profits on the short.

Support and resistance levels should not be used as indications to put on new long or short positions. They can, however, help to determine when to take profits. The one exception is that a stock that has a breakout will often return to the breakout level. If you wait for pullbacks before buying or wait for light-volume rallies before shorting, expect a return to the old support or resistance level and a confirmation that it's time to put on the position. But it's not the primary reason for putting on the position; the power box out of a consolidation is the primary signal.

Trendlines and Channels

We've been looking at horizontal lines that define the tops and bottoms of sideways consolidation areas. But as prices move up and down, they are also often contained within sloping lines. We tend to draw a pair of parallel lines, enclosing the price trend. However, the more important line is the line across tops in a decline and the line across bottoms in an advance. They show the levels where we have to become concerned.

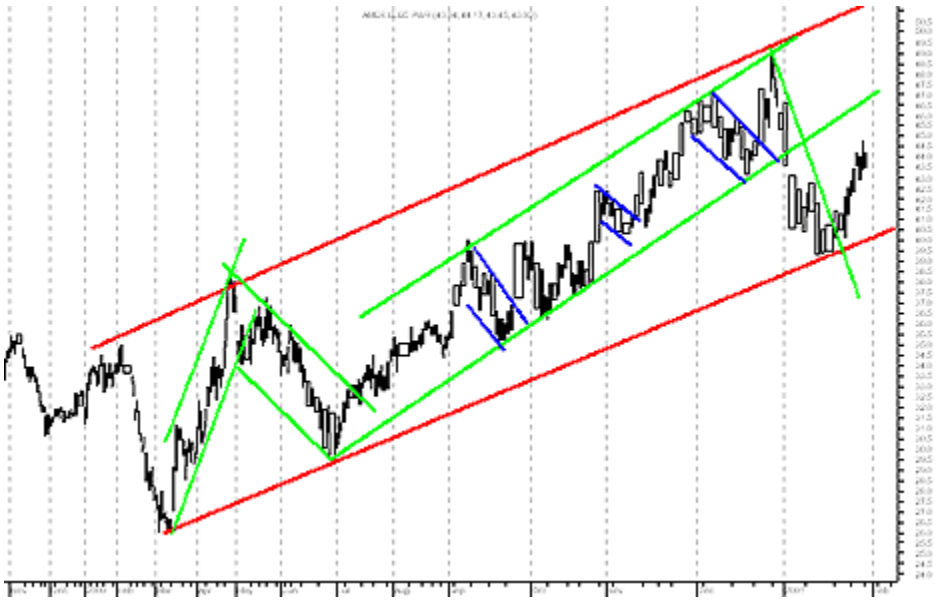
If we are short, we don't want to stay with the position if it moves out of its down channel to the upside. If we are long a stock, we want to cover the position if it breaks the lower ascending trendline, indicating a loss of momentum. In addition, of course, we want to look at the type of Equivolume box involved in the reversal. Heavy volume and a big range are much more bothersome than a light-volume small penetration.

Source: Metastock

The above chart shows both a down channel and an up channel, as well as volume emphasis. All the way down, volume increases on drops and decreases on rallies. All the way up, volume tends to pick up on rallies and drop off on pullbacks.

The Equivolume box at the transition point is especially interesting. It is a typical power box to the upside. It penetrates the descending trendline, making it clear that it's time to cover short positions. It's only saying that the decline seems to have halted, not that it's headed higher.

The buy signal is seen a couple of weeks later when another power box penetrates resistance after a base-building period. In this case, it means buying at a higher level, but after a sign of strength.



Source: Metastock

More often, though, there are trends within trends within trends. On the above chart, we're looking at a longer time frame than in previous examples, to see the various trendlines that can be inserted. The major trend is outlined with the two red lines. Inside that, we have a number of large price swings, each designated with a pair of green lines. Within those trends are a number of minor trends. I have shown a few of them with blue lines.

For our purposes, we'll try to play intermediate-type moves. The very small moves are usually counter to the trend we are trading. They are the pullbacks during an advance and the rallies during a decline. They are very valuable, though, as an indication of the limits of the trend. Moreover, they tend to confirm the validity of the position.

For example, during an up move, when we are long, we like to see the pullback made with lighter volume, usually getting even smaller as the correction progresses. Those pullbacks are the profit-taking that needs to be absorbed on the way up. It is healthy and expected.

If, however, the volume gets heavy on a pullback, it's a warning that the sellers are getting the upper hand. If the trendline is penetrated, it says the sellers are too aggressive. We like light-volume pullbacks that stay within the trend.

Gaps

A stock will often have a gap in its trading pattern -- an area of prices where no trading has occurred. It happens when a stock opens sharply higher or lower than the prior day's trading range and never moves back into that area.

Classic technical analysis classifies them as one of four types, depending on where they occur: trading range gaps, breakaway gaps, runaway gaps or exhaustion gaps. Using Equivolume, we find that volume makes it far easier to see what kind of gap we're dealing with, and therefore what we're likely to see for price movement after the gap.

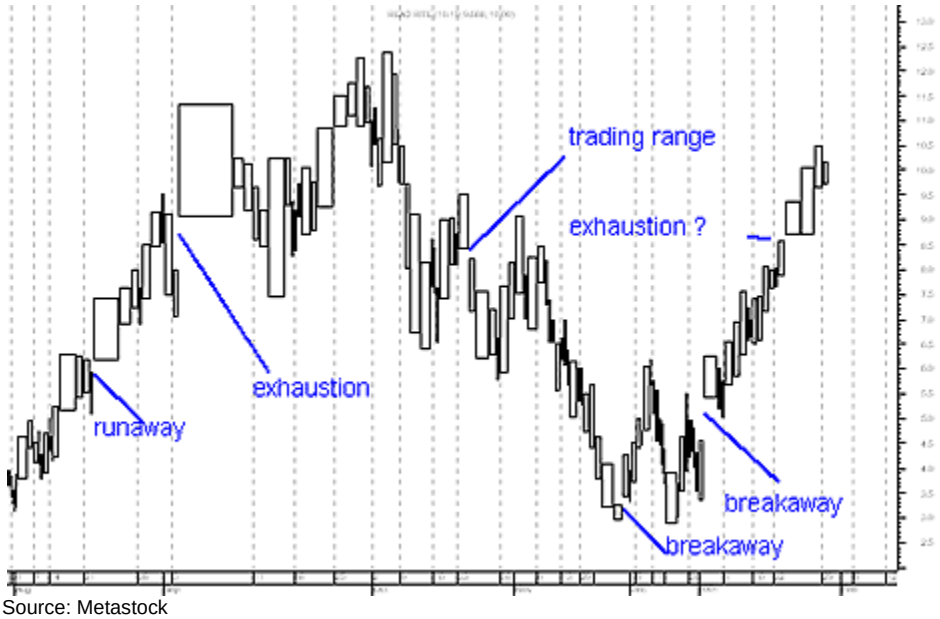
Trading range gap. This usually consists of two boxes of about the same size and shape on both sides of the gap. It's usually not accompanied by the penetration of an important support or resistance level. It doesn't mean much.

Breakaway gap. This kind is usually quite dramatic. The stock moves up or down out of a sideways area with so much power that it leaves a gap behind. It's a power box, but even more so. In a breakaway gap, both volume and price range expand across the gap. That means a small Equivolume box followed by a large Equivolume box that is quite tall for its width. A breakaway gap is a strong signal to buy or sell, depending on its direction.

Runaway gap. This is seen when a stock is rising or dropping so fast it leaves holes in the trading along the way. It is a sign of a very emotional move and usually implies it has further to go. It is identified by two boxes, both large and both tall for their width. It is like two power boxes separated by a gap.

Exhaustion gap. This is a sign that a move is ending. It's characterized by a tall, thin box, followed, after the gap, by a short wide box. It shows us that a very powerful move has suddenly encountered a barricade to further movement. It's like the oversquare boxes, but preceded by a gap. It is usually a strong sign to close out a position.

On the chart below, we see a number of labeled gaps.



Source: Metastock

Some stocks form many gaps, and others form very few. But whenever a gap is encountered, it should be considered and categorized. Gaps are a strong indication of where price will go.

Now I'd like to wrap up this series with some closing thoughts about Equivolume charting and how you can use it to be more successful in your trading.

Conclusions

Aggressive traders need to use every bit of information available to make unemotional decisions. But the deluge of fundamental information in the marketplace is overwhelming. Moreover, there's no way traders can see every piece of information that may influence the price of the stocks they're trading. Even if they

could, they'd still lack the most important ingredient: the psychological effect of that news. It is useless to know the news and not know how it will influence the thinking of the millions of people who are reacting to that information. What is needed is a machine that will assimilate every known piece of information, ascertain the psychological response and apply it to the price of a stock.

Luckily that machine exists: it's the market. Every tiny bit of information that could influence and engender an emotional response does so. People buy and sell stocks in response to those emotional responses. Those responses are reflected in just two final pieces of information: price and volume. All a trader needs to do is observe the way in which price and volume are exhibiting themselves in the marketplace to know exactly how the world is evaluating all of the information known or even suspected concerning that stock.

Equivolume charting does not look at any new information; it just looks at the same information in a more easily interpreted format. It allows us to more easily ascertain how prices are changing, rather than just seeing that they are changing. It shows the internal dynamics of a stock. Volume is treated as an equal partner to price, rather than an afterthought at the bottom of the page.

None of the methods we have covered is foolproof. There are always going to be losses as well as gains. The objective is to have more good trades -- and larger profits on the good trades -- than losses on the bad trades. Doing so calls for discipline and objectivity. That means not only reveling in the successes, but accepting the failures and moving on. It also means having the strength to quickly move out of a position as soon as the evidence says it is time to do so. No stock can be your friend or your enemy. Successful trading is not based on luck. It is based on knowledge and ability.

Richard Arms is a renowned stock market technician who invented the Arms Index (often referred to as the TRIN), which has become a mainstay of market analysis, appearing in The Wall Street Journal and Barron's. Arms also developed the widely used technical method Equivolume Charting. Since 1996, he has been publishing the Arms Advisory newsletter for money managers and financial institutions. He also has authored four books, including Profits in Volume and Trading Without Fear, and has been honored with the Market Technicians' Award for Lifetime Contribution to Technical Analysis. At the time of publication, he had no positions in stocks mentioned in this report, although holdings can change at any time. Under no circumstances does the information in this commentary represent a recommendation to buy or sell stocks.

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