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### Finding Momentum Early

# The Alter Ego Of Swing Trading

*With so much coverage of blue-chip companies coming from popular media channels, tweets, or social chat rooms, traders often overlook small-cap stocks, which provide wider spreads and more liquidity. Find out how to capitalize on them.*

**by Martha Stokes, CMT**

While most retail traders continue to trade only Dow 30 stocks or large blue-chip stocks, they are missing out on an opportunity for swing trading. Why opportunity? In October 2016, a major internal change in market structure was set in place. For the first time in over a decade, spreads widened, as the Small Cap Pilot Test Program that had been going on behind the scenes was finally approved by the Securities and Exchange Commission (SEC). Since then, professional traders have been highly active in small caps as liquidity increases with wider spreads.

At the same time, the SEC also started another test program that is currently being evaluated called the Tick Size Pilot Program. This program includes a much larger base of securities in order to expand on the original concept that wider spreads in a broader base of stocks could provide more liquidity for all short-term traders.

These two changes are extremely important for retail and technical traders. The test program uses five-cent increments instead of the penny spread. With wider spreads and more liquidity, coupled with the smaller number of outstanding shares typical with most small-cap companies, the opportunity for swing trading has grown in just a few short months. However, there are some differences and variables in trading small caps to be aware of.

## What are these differences?

Unlike with large blue chips, choosing a small cap with a wider spread is not going to be based on news, tweets, chat rooms, or social media posts. These small caps rarely come up as recommendations or in retail news. Instead, choose small caps to trade based on pure relational technical analysis.

The key elements of swing trading these wider-spread stocks are:

1. ***Small number of outstanding shares.*** The limited shares provide momentum energy, as demand for the stock increases during speculative activity.
2. ***High percentage of shares held by institutions.*** The higher the percentage of shares held by institutions, the more energy and momentum they can have, because stocks held for charters and trusts increases the demand-to-supply ratio. Dark pool buy-side institutions invest heavily in small-cap stocks that have huge growth potential. As exchange traded fund developers buy small caps to fill niches of their inventory for exchange traded derivatives, more shares are held in trusts.
3. ***Market participant groups actively trading the small-cap stock.*** Professional traders prefer small caps, as runs can be controlled and tend to sustain longer. High-frequency trading firms are also taking advantage of the five-cent spread for faster profits.
4. ***Liquidity is also important.*** Not every small-cap company is a good candidate for swing trading, just as not every large blue-chip company is ideal for short-term trading. Liquidity equates to whether or not there is a high interest from the buy-side institutions.
5. ***Market conditions are also a factor.*** The dark pool quiet accumulation patterns show up best during bottoming, platforming, and quieter market conditions. Dark pools tend to cease their buying during speculative market conditions.

To identify key elements in stock charts for small-cap swing trading, additional indicator tools are necessary to reveal where dark pools (which are basically bids and offers by brokerages and exchanges that are not displayed to the public) are quietly accumulating, where professional traders are moving in with end-of-day buying or selling in anticipation of high-frequency trader trigger action, and to confirm the run has sufficient underlying energy to sustain excellent point-gain potential for higher profits.

An example of a small-cap stock that moved with momentum out of a bottom is Silgan Holdings Inc. (SLGN) with 55 million shares and just under 80% institutional ownership (Figure 1).

To trade these sudden momentum moves *with* the run rather than *chasing* the run, you would need to use alternative indicators that can reveal quiet accumulation by dark pool buy-side institutions, professional trader footprints, and potential high-frequency trader triggers. These three market participant groups work in tandem to create the huge sudden runs that are highly profitable for retail traders, *if* they learn what to look for in the stock chart and enter the trade prior to the sudden momentum action.

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**FIGURE 1: A POTENTIAL BOTTOMING PHASE.** Here, SLGN is attempting to develop a bottom formation. It may be necessary to use alternative indicators that can reveal quiet accumulation by dark pool buy-side institutions, professional trader footprints, and potential high-frequency trader triggers.

## Finding momentum

The analysis includes a relational interpretation and summation of what has occurred during the potential bottoming phase. Analysis is therefore first on price action, using candlesticks that are unimpeded by any indicators on the candles, which provides better readability of the price action. Second, we can then look at several indicators that reveal accumulation by dark pools, professional trader trading activity, and trigger areas for high-frequency traders. Let's review what some of these indicators are.

**Huge, sudden runs in price can be highly profitable for retail traders, if they learn what to look for in the chart and enter the trade prior to the sudden momentum action.**

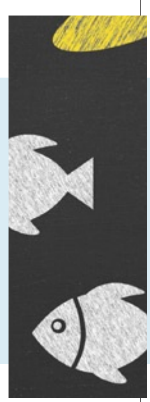

**FIGURE 2: A MOVE DOWN BEFORE CYCLING BACK UP?** For SLGN, accumulation is set in a specific range. The accum/dist indicator warns that it is premature to buy this stock. The Chaikin oscillator (ChiOsc) is also a good indicator for analyzing a bottom formation.

**FIGURE 3: THERE SEEMS TO BE A SHIFT IN THE DYNAMICS.** SLGN is working on its bottom and continues to move up and down in a range-bound fashion. This reveals continued accumulation within that range.

In Figure 1, we can see dark pool quiet accumulation underway in SLGN. The range for the dark pool *time-weighted average price* (TWAP) orders is clearly defined. TWAP is a highly flexible professional order type that has a distinct price pattern on charts when being used as an incremental method of accumulating stock over an extended period of time. TWAP is the favored order type by many professionals. It allows them to route their order and control the entry in a variety of ways. It automates accumulation over time.

Next, the *accumulation/distribution line (accum/dist)* is an indicator that is available in many charting software programs. When read properly, it provides invaluable information as to whether the order type used is a TWAP or *volume-weighted average price* (VWAP), which is another professional order type that also reveals which market participant group is accumulating. Smaller funds prefer using VWAP order types.

The TWAP order instructs to buy *x* number of shares when the stock hits a low, and then continue incremental buying over time until the stock reaches a specific high price. At that time, the TWAP order ceases to enter incremental orders. The range for this bottoming stock is clearly defined by price and how the accum/dist indicator is behaving. Note that as the stock reaches the high of the range, accum/dist declines even though price holds in a consolidation pattern near that high.

*Volume bars* are another key element of the analysis. Note the high volume surges as the stock bounces off the low in October as TWAP orders trigger. High-frequency traders (HFTs) create surges of one-day volume due to their millisecond trading. The gap is caused by HFTs but as soon as the stock reaches the high of the range, dark pool TWAPs stop and professional traders take profits. Meanwhile, smaller funds' VWAP buy orders are firing off at the highs of the range due to the HFT spikes of volume.

The accum/dist warns that it is premature to buy this stock, as the stock is likely to move down before cycling back up (Figure 2). The *Chaikin oscillator* (ChiOsc) is also a good indicator to use in this Relational Analysis (the name I gave to this analysis technique I developed) of a bottom. Volume oscillators are essential for the new market structure, as these indicators provide more valuable information on volume action in relation to price. With the chart in Figure 2, right at this point, the volume oscillator has formed a negative divergence from price, which is a clear signal not to enter the stock yet.

Building watchlists for stocks undergoing a bottoming formation is a good habit to develop. These are not stocks to discard out of hand.

But the dynamics between the three volume/time-based indicators has changed. The indicators hit an extreme low and moved up even while an attempted sell down by a high-frequency trader trigger failed (Figure 3). The extraordinarily long red volume is due to a premarket flood of HFT orders attempting to sell the stock down. However, dark pools have raised the entry trigger level for their TWAP orders. The base of the bottom has been moved up. This is a significant development for this bottom. The sideways pattern is compressing but is still rather wide for an entry. The volume weight has shifted to the buyers. Watching the stock more closely for an entry is important at this juncture of the bottom.

Price has compressed from a wide sideways pattern to a consolidation. Like a compressed spring, this action is controlled by professional traders who have been monitoring the progress of dark pool quiet accumulation (Figure 4). Dark pools have completed their accumulation and soon the news will leak out of their interest in this stock, similar to retail gurus' recommendations. The stock is hovering close to the highs of its range, which is another significant price-to-volume indicator relationship.

ChiOsc is oscillating consistently above its center line, which is indicative of professional traders entering in anticipation of a sudden momentum run. Accum/dist is holding steady, because professional traders tend to pack large lot orders. It is not uncommon for volume bars to drop below their average just prior to a momentum run.

SLGN shows the results of dark pool quiet accumulation, which is a liquidity draw on small-cap stocks with limited outstanding shares; the activity of professional traders reacting to the liquidity draw, which they can easily identify on their professional software and platforms; and the energizing of HFT algorithm automated triggers.

The *acceleration and angle of ascent* of price and volume indicators is created by smaller funds' VWAP orders triggering on HFT volume surges.

For the retail trader who wants to enter this type of trade at the onset of the momentum run rather than chasing the run, it is merely a matter of learning to read the following:

1. Price patterns in relation to volume indicators, which reveals who controls price, and how price is being controlled
2. Understanding the dynamics of sideways price action, and what it means in relation to the current market condition and trend patterns for that stock
3. The influence of professional traders and how they track liquidity draws
4. How professional trader buying patterns trigger high-frequency traders
5. When smaller funds and the retail crowd are likely to chase the run.

**FIGURE 4: A COMPRESSED SPRING ABOUT TO LET GO.** SLGN has the pattern of price and volume indicators that swing traders can extract a lot of information from. This action is controlled by professional traders who have been monitoring the progress of dark pool quiet accumulation.

## Study your charts

Relational Analysis is a way to study charts that uses all three data sets of price, volume, and indicators such as accum/dist and ChiOsc in ways that allow the retail trader to understand what is going on, so that the entry for a swing or momentum trade can be better controlled and is at the optimum entry price.

Although this type of analysis is more sophisticated than some approaches, it does not require any more time. Rather, it is a matter of altering your perspective of an approach to selecting stocks to trade. Small-cap stocks now offer wider spreads, which results in longer runs, higher point gains per run, and, if properly executed, a higher-profit trade.

Taking fewer higher-profit trades will earn far more income annually than taking numerous low-profit to small-loss trades. Most retail traders trade too often and lose money rather than watching for high-profit trades and entering earlier.

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## Further reading

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