

**Market Profile™, Auction Market Theory
and
Behavioral Finance**

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Investopedia defines Behavioral Finance as, “A field of finance that proposes psychology-based theories to explain stock market anomalies. Within behavioral finance, it is assumed that the information structure and the characteristics of market participants systematically influence individual investment decisions as well as market outcomes”. This field of finance believes that it is the collective decision process of the traders or investors that determine value in a market or an equity. The field also recognizes that the psychology of the investment community is influenced by several factors, including the failed decision process of that community and the tendency for the community to act with a “herd” instinct.

We must always keep in mind the importance of understanding the environment of the markets we trade. That understanding is never more important than in the current markets. Environmental factors include any information that may come into a market to change the perception of value. If we understand the environment, then we can also anticipate information that may change that environment and value. Markets are generally in motion. Traders buying and selling are always probing for higher or lower prices. Their determination of where price is fair or unfair will cause them to buy or sell. Additionally, their perception of what the rest of the traders perception of value is will cause them to make investment decisions. The interpretation of those forces will have an effect on their perception of value in the marketplace.

There are a lot of newsletter writers who spend much of their time analyzing these issues and predicting expected outcomes. Economists have spent their lifetimes developing economic models to predict the result of inputs and outputs on economies. There are a lot of individuals who digest as much of this information as possible in order to better plan for their own trading and investing. Then, there are those who prefer to hibernate, trade mechanically or mathematically and never want to be influenced by the environmental factors that surround them.

Behavioral Finance and Behavioral Economics believes it is not fundamentals that drive value and it is not technical patterns that drive value. It is the reaction of the human community to events and their interpretation of those events that determine value, whether the human interpretation is correct or incorrect. We have seen some of this in recent economics. When the 2008 recession began, the reaction to the news was for consumers to begin cutting back in anticipation of unknown consequences. Certainly the jobless rate increased, but consumption fell dramatically. This means that even those with jobs cut their spending. While the majority of workers were not affected by the recession, their psychology changed and they reduced consumption and were part of the reason the recession deepened. As stocks began to sell off, that same selling drew in more sellers as markets fell. This type of “herd” instinct can lead to worsening recessions. This is why we find the government and

pundits always trying to skew the good side of the recovery. Their intent is to “influence the herd mentality”.

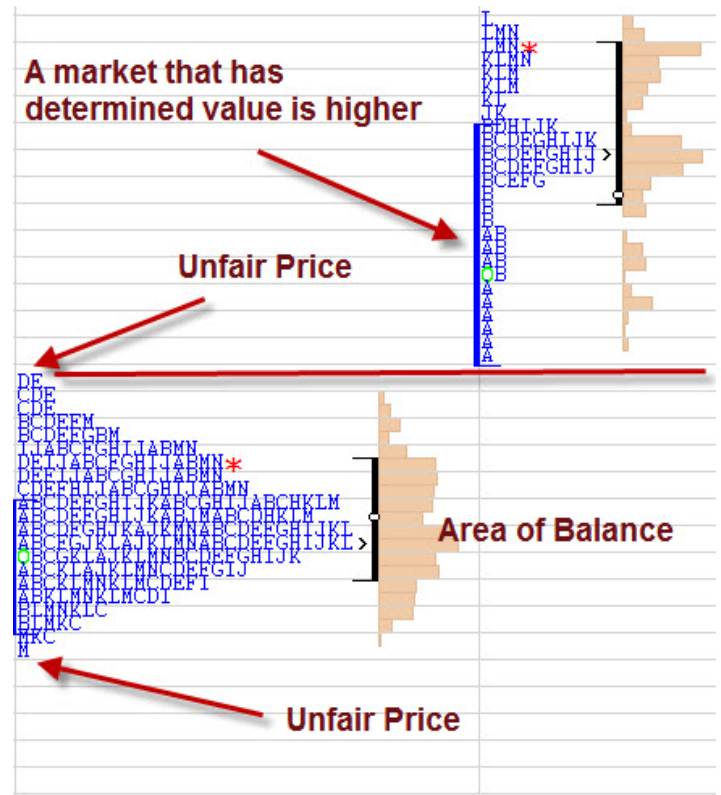
Economists and analysts can prepare models and market analysis that predict certain outcomes as a result of inputs. However, what they exclude from their models is the reaction of the investment public to that information. We see many times a company will issue a better than expected earnings report only to find the stock moves lower. At the beginning of March 2010 we saw the jobless rate climb and the market rallied. These situations are difficult to predict. Recently, we found in the news that Warren Buffett can borrow money cheaper than the US Government. It is the feelings, emotions, and instincts of the trading community that in the end determines value. In the case of US Treasuries that are guaranteed by the US government, the psychology of Treasury traders was that Buffet was more secure than the US government and therefore the government was charged a higher rate of interest to compensate for that risk.

I am not making the case that economic, technical and fundamental analysis is not valid. They certainly are and their results do change the environment of markets and how individuals react to that information. My point is that the reaction is not always as predictable because of human behavior. More pointedly, it is not the information that drives the market, it is the psychological reaction to the information that drives the market.

The result is that we can read all of the economic analysis we want. We can read research reports and gather all types of information, but the end result is the reaction of the investment community to that news.

Auction Market Theory is the study of markets based on a willing buyer and a willing seller and their intent to facilitate trade by bidding price until there is agreement on value. The theory is that individuals, with their perception of value will bid back and forth until value is agreed on and trade facilitated. Buyers and sellers are constantly bidding up and down until there is an area of price where the most trade is facilitated. That area will remain constant until the psychology of those buyers and sellers changes and they drive price either higher or lower.

There is one way to chart the psychology of the traders and their determination of value. It is in the Market Profile™ chart. This graphic is a tool that does not tell us what the outcome will be, but that a market is at an area of “value” or an area of “unfair” price. An area of “unfair” price is



where a market has moved from value or balance to potential imbalance. It is from the study of value and where the community has determined value in the past that we can see potential changes in that determination of value. When price reaches what was determined as “unfair” before, we know it is an area where a potential change in the determination will be made.

In the Market Profile™ chart traders and investors can easily see how trade was facilitated in the “Bell Curve” formation. Each time price rotated up or down to try to extend outside of that Area of Balance, price was rejected and it rotated back to the center or the area where the most trade was facilitated. Finally, on one day and for whatever reason, the psychology of the traders changed. Some obvious information came into the market that changed their perception of value. The market opened at an “unfair” price and immediately began to move higher. Thus, a signal the psychology had changed and the market was seeking value at a different level.

When a market trades into an area of “unfair” price, traders and investors can use that area to a strategic advantage. Through an interpretation of market internals the strength or weakness of the move into that area can give the individual a high probability assessment of either rotation back to value or vertical development of the market where value is determined to be higher or lower.

While using the graphic to determine trade strategy, a trader or investor is faced with two choices. The market will either rotate back to value or it will go into vertical development and seek value at a different level.

While this article is not meant to give a full explanation of how to interpret the Market Profile™ graphic, it is its purpose to give two very important propositions for consideration:

1. It is the psychology of the investment community (Behavioral Finance) and its reaction to information coming into that market that determines value.
2. The perception of value and “unfair” price can be visually seen in the Market Profile™ chart. Therefore, the Market Profile™ chart is a graphical depiction of the psychology, emotions, failed decision process and “herd” instincts of the investment community.

Through the Market Profile™ chart and through understanding it in multiple timeframes we can see the psychology of the market. When it moves to a point where the community has rejected price before and we know there is potential news that could change that perception of value, we know the market has moved into an area of good trade location. When these areas of good trade location occur, it gives the trader or investor an increased probability of success because whatever the psychological reaction a trade can be placed with a higher degree of success probability.

While many traders use different systems and oscillators, it is the student of Auction Market Theory who can see where value was found in the past and can develop a trade strategy that will give him/her an edge over the competition. Understanding this graphic and interpreting information that comes directly from the market takes time. However, once the learning process begins, the trader or

investor realizes immediately the incredible tool he/she has at their disposal in developing trade strategy.

Based on the above, it can be concluded that having an understanding of the Market Profile™ graphic and knowing how to read market internals is a tool that gives the trader or investor the ability to read information that is coming directly from the market itself. The technique then automatically includes an analysis of not just all of the fundamental and economic aspects that can affect a market or equity, but also includes the psychology of the investment community and their interpretation of that information and its resultant effect on value.

This “all encompassing” methodology has the ability to provide the trader or investor with excellent trade location.