HARNESS THE MOTION OF THE MARKETS

By Colson Hauser

No matter the reason, the market is in constant motion. The bid and the offer are changing continuously.

Traders can use scale trading to profit from that continuous movement. Like a hydroelectric plant harnessing the power of a river already in motion, this methodology sets itself to profit from the continuous flow of *volatility*.

Scale trading differs from other strategies, because its assumptions do not rely on an ability to predict the direction of a market. Nor is it inherently reactive.

GETTING STARTED

The basic premise of scale trading is to create a fixed set of buy and sell levels over which the market moves. The more the market moves over these price points, the more profits are created.

Choose a starting price point. When the market drops, buy one futures contract at predetermined increments — the buy interval. Each time a contract is bought, it adds to the inventory. For each contract bought, a sell order immediately is rested above the buy level at a predetermined sell interval. The sell interval determines the gross profit per trade.

When the market rallies, filling a sell order to offset a corresponding long contract, immediately place an order to re-buy that contract at the original buy level. This repetition of buys and sells generates profit for the account as long there is inventory to sell. The more volatility, the more frequent the buys and sells. If the market rallies above the entry point, all positions are offset at a profit, leaving no inventory.

THE RISK

Calculate the risk as the market drops to a given price by finding how many contracts are in the inventory, the necessary *margin* to hold those contracts and the open trade loss based on the average price of the inventory. The maximum risk is calculated by assuming (however improbable) that the market goes to zero. Calculate the margin requirement and open trade loss at that point based on the average price of the inventory.

These potential losses may be substantial. Trading should only be done with true risk capital. The investor must have access to the risk capital necessary to meet the worst-case scenario.

The particular risk of a scale trade setup is inversely tied to the buy

Three Assumptions

1. The chosen market will not go to zero.
2. There will always be some degree of volatility in the market.
3. The investor must have the financial and emotional capacity to cover a worst-case scenario.

Possible Outcomes

Past performance is not indicative of future results.

1. Price goes to zero. The exchange stops facilitating that market. Open trade losses are offset by profits made along the way. Worst-case scenario.

2. Investor prematurely quits and realizes large, open trade loss offset by profits made along the way. Avoidable.

3. Market rallies above the highest sell level. Investor has offset inventory for profit. Re-assess and decide if re-entering the market at a higher starting point warrants the risk. Most likely scenario.

4. If the market continues to oscillate beneath the starting point, profits can be generated until they outweigh the maximum possible risk and beyond.

Colson Hauser shows how this works on a chart.

interval. Contracts are bought less frequently with a larger buy interval and vice versa. Investors with given risk tolerances may tweak the intervals to match their situation. Furthermore, starting the scale at a lower price point will lead to less potential maximum risk.

THE REWARD

Profit is directly related to the volatility. Every time the market rallies by the sell interval, a respective long position is offset for profit. The smaller the sell interval, the more frequently one can sell and re-buy a given price level. The maximum possible risk is finite, but profits are generated so long as there is inventory. Ideally this happens until the profit outweighs the maximum possible risk.

VOLATIILTY CAN DRIVE GAINS

Scale trading is not for everyone. For those who can understand and sustain the risk, consider allowing volatility to drive your gains. Eliminate the inherent risk in trying to predict the direction of a market.

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