

Active Boundaries and the Risk/Reward calculation

This document was written in October, 2009 by Pascal Willain as part of a training program on the use of the Effective Volume tools.

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The author is French speaking.
This report has not been proof-read for the proper use of English language.

AB stands for "Active Boundaries". The idea behind the AB concept is that a set of active traders who constantly monitor a specific stock will reverse their position (long or short) when their collective average profit reaches the same value that was hit in the past.

For example, if in the past, the active traders sold a stock when their collective profit was 25%, they will continue to do so in the future, unless the market conditions have a fundamental change or the value perception for the stock is changing due to for example better than expected earnings or due to a profit warning.

This idea is very similar to the VWAP concept that finds the weighted average profit for a period of time, except that it is applied to a fixed number of shares, which I call the active shares. How to calculate these is an iterative process that I explain in the VIT book (Ch 2)

The aim of AB is to catch a trend between two boundaries: UB (Upper Boundary) and LB (Lower Boundary). NB is the Neutral zone, indicating the zone at which no one is earning or losing money on the stock on average. This NB is equivalent to the price back to its VWAP line or often a strong stock back to its 20 or 50DMA.

In the trading ideas table, I always calculate the distance to UB for long plays and to LB for short plays. The Reward/Risk ratio is the ratio between this distance and the maximum loss I am ready to take (stop loss of 8% for example for long plays). However, if my entry price is more than 8% above the neutral zone, I set the system to issue a warning, because the neutral zone is the first support zone in case of pull-back.

Let's take two examples: EJ and ISRG

For **EJ** shown below, we can see that LB and NB are very close, but that UB is far away. This indicates a strong up-trend.

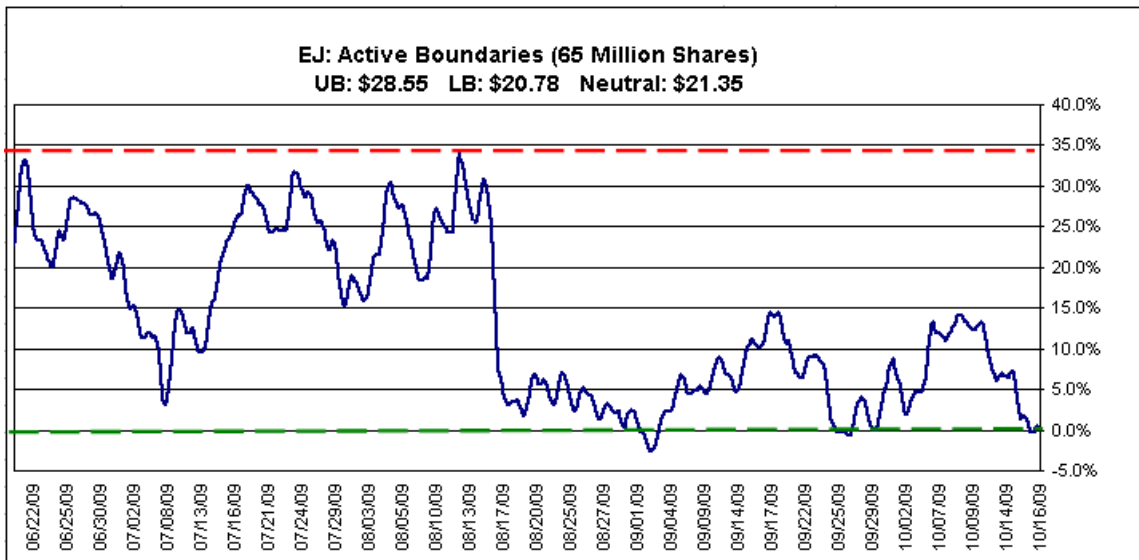
(The strength of an uptrend is measured by adding UB to LB. In a downtrend, this number would be negative).

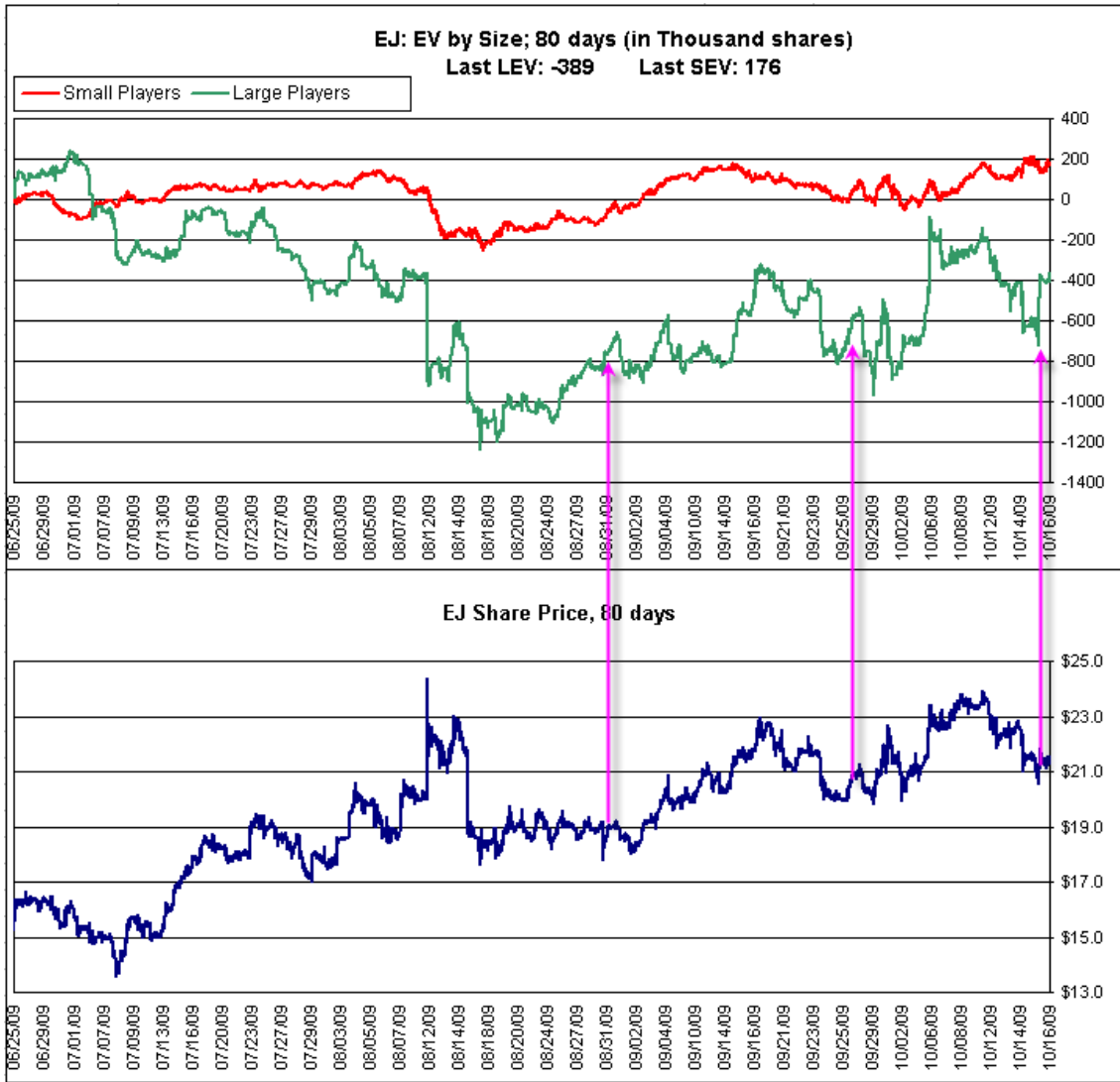
You can also notice that the 50MA is giving about the same signal as the LB.

The combination of AB to EV is rather powerful, because this allows you to detect if money is moving into the stocks at the critical place where it should move.

If this is the case, I'd buy at these critical points, but would sell if the stocks falls below these critical points.

EJ (E-House (China) Holdings Ltd.) NYSE © StockCharts.com
 16-Oct-2009 **Open 21.11 High 22.00 Low 20.50 Close 21.40 Volume 3.1M Chg -0.09 (-0.42%)**





ISRG shows another interesting pattern:

You can see that the standard TA shows an increasing price, while the AB shows a decreasing pattern. AB is indeed an oscillator which tends to come back to the neutral zone "0%". Indeed, as ISRG is building a new base, new shareholders come in to replace previous shareholders who are taking their profits out. These new shareholders have 0% average profit and replace old shareholders that carried a healthy average profit (that is the reason why they sold). As the base builds up, there will be fewer and fewer sellers the closer we get to the neutral zone, because at the neutral zone, there is no profit to take away anyway, hence the reversal back-up as soon as the first large players move in.

The fact that large players sold (See blue arrow) at some point is normal profit taking. This is not enough to break a strong stock. A strong stock breaks when the price breaks and the AB pattern falls below LB. This often means that the perception of value has changed either for the stock itself or for the whole market.

For ISRG, \$240 is the ideal buying spot, because of the 50MA support and the NB. However, I am not sure that the market will give such an opportunity again for this stock.

Another important characteristics of the UB target, is that it is fixed in terms of percentages but it constantly moves in terms of price. For example, the UB for ISRG is now 33% and 318\$. However, as soon as the price starts moving up, new shareholders continue pulling the AB signal down, while the price increase pushes the signal up. The price increase is stronger than the change of volume which occurs only slowly (compared to the size of the Active Float). However, since the 33% are fixed, the target price to reach the UB will slightly increase to the equivalent of the pulling move set by the new shareholders. Therefore, the real UB target will be higher than 318\$ and could easily reach for example 330\$.



