Cambridge Trader's Institute
The Future Of Professional Market Trading

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Richard Rizzo Stock Market Trader - Trading Imbalances

On the last Friday of every June comes a rather unique phenomenon: the Russell re-balancing. The Russell 3000 is an index, which tracks 3,000 of the largest stocks in the U.S.; approximately 98% of all investable U.S. stocks are included in the index. The Russell company adds stocks to its indexes on a quarterly basis, but it deletes stocks just once a year. This year, 278 companies will be added. Index and various asset managers try to reconfigure their own portfolios to accurately show the make-up of the new grouping of stocks in the index. Many Russell or small-cap managers in particular are forced to do this reconfiguration by the close of business today. Thus, on the close, volume often surges because of the influx and outflow of monies in the stocks going in and coming out, respectively. Many years, there will be millions of shares to buy on the close of the Russell stocks which are offset by, say, institutions which use the volume to exit positions of stocks that they no longer wish to hold thus stocks rally on the close. In the rare year (and this may be one of them), the desire of fund managers to exit their positions in select stocks outweighs the buying of Russell managers and stocks fall on the close. Most years, it is totally offset because everybody knows everything. All of this in mind, short of entering orders on every stock going into the index, the best strategy for the close is to watch for order imbalances and simply play the biggest ones. The 'fun' ones often occur first, i.e. the ones, which have 75,000 to buy or sell, and they have traded 2,500 shares on the day. But the ones that work best are the stocks that have the biggest imbalances because those are hardest to offset so spend time looking for things like multimillion shares imbalances in stocks like Visa (V). In addition, remember to expect absolutely nothing out of it, but definitely hope for the best because it is occasionally the most profitable day of the year for many day traders.

According to Richard Rizzo, one of the major benchmarks for inflation in the United States is the Commodity Research Bureau Index (CRB). Among other things, it measures the value of metals, textiles (such as cotton), livestock, fats (like butter), raw industrials (such as steel scrap), and random foodstuffs (such as cocoa or wheat). Among the statistics buried amid the soaring price of oil, the plunging value of the Dow Jones Industrial Average, and the general worries over the world's economies is the fact that this index is up 31% for the year. 31 Percent. Whether this is a bubble or sustainable is certainly not relevant to a day trader on any given day. What is important is that this is another piece of the big picture. Go to a grocery store. Since mid-2004, a box of San Giorgio pasta has risen from 33 cents to $1.39. And specifically, basing it since the beginning of 2008, the price went from $1.05 or so to $1.40. Yet, inflation is discussed as being under control according to official government statistics and most common economic measures. This is worth a few precious lines in this space because it is simply something else to keep in the back of the mind of the day trader. Commodity prices have risen much more than the average intelligent person can fathom. This is not an avocation to buy or sell any particular stock. However, this type of statistical change (31% in six months?!) is certainly something that should be monitored by the trading community because if it accelerates or decelerates, the breadth of the move of the market will be even more powerful than it has been in 2008.

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In the midst of a slow news spate such as this, it is important to take a little time out to prepare for the very busy earnings season ahead. One of the features of this strategy require we do many news-centric trades thus the inundation of earnings news during the height of earnings season is typically a highlight of the quarter. Typically, most companies base their earnings on the end of each quarter (i.e. Mar. 31, Jun. 30, Sep. 30, and Dec. 31). However, it takes the major accounting firms 2-5 weeks to properly tally the results of the major corporations found throughout the United States. Thus, the 15th of the first month of each quarter through the 15th of the 2nd month of each quarter is typically an extremely busy time for day traders who do news-centric trading. Specifically for Intra-Day Traders, the blog will look a bit different during that time, as many of the plays will be based off earnings flow and occur anywhere from 7AM-11AM ET. Some days will include a commentary; other days will just have a trading lesson featured due to a dearth of time. Same quality…different theme. The watch list can also change wildly between 7AM and 11AM as stocks consistently move up and down the list based on how they perform in terms of volatility. What we try to do during that time (as we do every day) is to rank the stocks from most likely to trade to least likely to trade as there will be literally hundreds of stocks on the list on some days. But, keep in mind in this calm before the storm that the blog will be choppier with the list subject to change at a moment's notice; the list sent out each morning will be a snapshot at the time the e-mail is sent, but be aware that you cannot just rely on the top 10 or 15 because every stock on that list will be important.

One of the unique features of the NYSE and AMEX in particular is the concept of an order imbalance. An order imbalance occurs as a result of a case when a vast disparity exists in buy and sells orders for a particular stock, which makes it extraordinarily difficult to find an equilibrium, which matches the interest of buyers and sellers. For stocks that are on a listed exchange, a specialist firm can provide liquidity if the move is not overly dramatic. If there is an extreme imbalance, the stock is often halted. For instance, if a stock is trading at 5 dollars per share and declares bankruptcy, the stock will certainly open much closer to 0 than to 5 thus there would be a massive 'sell imbalance.' The imbalances can occur whenever a major piece of news affects the stock price such as an earnings release or a merger announcement. The two times an imbalance typically occurs are before the open and just before the close. As day traders, we tend to be more interested in closing imbalances- particularly in smaller stocks. One type of order that traders place is called a 'market on close' order. So, if five people placed orders to sell 1,000 shares of Visa (V) on the close via a market on close sell order and one person put an order in to buy 2,000 shares of V on the close via a market on close buy order, the net imbalance would be 3,000 shares to sell (5 people multiplied by 1,000 shares each minus the one buyer of 2,000 shares). The imbalance information is first posted at 3:40 PM ET (20 minutes before the close) and updated at 10 minutes before the close (3:50PM ET). At the 4PM close, everybody- buyer or seller- receives the final price of the day in one print. As day traders, we seek to trade off of these imbalances in one main way. If there is a massive imbalance, one would want to place an order way away from the market and hope for the best. For instance, on March 7, 2008, Ambac (ABK) had an imbalance approaching 10 million shares to buy. At 3:59PM, the stock was trading at 6.75. Typically, most day traders place short orders at prices ranging from 7.25 all the way up to 8.50. The imbalance was so huge to buy, however, that the stock closed at 9.50. All of the traders who placed those short orders got filled at 9.50, a full 2.75 above the last sale price! Put another way, if the only reason a stock is driven up or down is because one huge players wants to get in or out, much more often than not, the market reverses immediately once the huge order is executed. People who were long

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at 6.75 and suddenly have stock at 9.50 want to do nothing more than sell. This is the logic behind fading the imbalance. The worst price covered immediately after-hours was at 9 as the stock found its way back down to below 8 quickly as the only reason the stock rallied like that was the one huge buyer. So, the net is this: we aim to look for gigantic imbalances. If the imbalance is to the buy side, we place orders to short well away from the market. If the imbalance is to the sell side, we place orders well away from the market to buy. Most of the time, nothing happens. In the times people are executed, the prices are far away from the current market thus leaving lots of room for error. Thus, it is the perfect type of trade; the worst risk is that one does not get filled and the best shot is that one gets a fill and immediately exits one's position immediately after-hours. And on no news, we love getting short a stock at 9.50 that was trading at 6.75 one minute prior.