Volatility-Based Technical Analysis by Kirk Northington

Reviewed by Mike Carr, CMT

Many novice technicians blindly trade signals generated by their favorite indicator. Eventually, they blow up their account unless they are fortunate enough to meet a more experienced technician who teaches them the valuable lesson that we actually trade price, not our indicators. After reading Northington’s original work, I realized that more than price, technicians pursue and profit from volatility. In this book, he offers insights into the importance of volatility to traders.

While profits and losses are measured by the entry and exit price, volatility measures the move that led to the trading opportunities. It is actually volatility which leads to profits, and without volatility, trading isn’t possible for the majority of traders. Flash trading, perhaps soon to be outlawed by regulators, doesn’t require volatility but does require lightning fast computer connections and physical proximity to exchange data. Likewise very short-term arbitrage trading doesn’t require price volatility as much as it needs technology and deep capital pools to generate profits. However, traditional trading, usually based upon technical analysis, does rely on volatility in prices to deliver profitable opportunities.

Northington has written for the advanced trader, but with sufficient desire, this book is perfect for the novice trader as well. The novice would simply need to refer a more general reference on technical analysis, such as Kirkpatrick and Dahlquist’s Technical Analysis, to understand some basic concepts. But it would be well worth the effort.

Volatility-Based Technical Analysis walks traders through the entire process of developing an indicator and designing a trading system based upon that indicator. Some moderately advanced mathematical techniques are used, but the author adequately explains the underlying technique before applying it. In the end, all questions are answered.

There are at least a dozen unique indicators presented in the book. Some are brand new, others variants of well-known technical tools being used in a new way. As an example of the latter, Wilder’s Average True Range is reworked to become TTI ATR Extreme (ATREx), which serves as a building block in a trading system but also offers a degree of usefulness as an indicator on its own. (The author includes the prefix TTI in all original indicators that he presents. This acronym stands for Trading the Invisible. More detail can be found at the book’s companion web site, www.tradingtheinvisible.com.)

The TTI ATREx normalizes the traditional ATR with respect to the close. It seeks to identify extreme overbought/oversold conditions. To do so, it should have higher absolute values when the closing price is significantly above or below the mean closing price and when the ATR is at a relatively high value. The formula is given as:

\[ \frac{(C - \text{Mov}(C, 40, E))}{C} \times 100 \times \frac{\text{ATR}(14)}{C} \times 100 \]

This calculation is multiplying the closing price’s distance from its 40-day exponential moving average by the normalized ATR. Visually, it is shown in Figure 1.
The ATREx can be further refined to develop entry and exit signals for a trade. The idea is to let volatility define overbought and oversold extremes in price. Most technicians rely on momentum for these types of signals and these indicators are known to have high failure rates, especially at market turning points. Northington presents an idea worth researching to reduce the bad trades generated with traditional tools.

While the book is written in an easy to understand style, Northington realizes that not every trader is a programmer. For that reason, he includes the MetaStock® and TradeStation® code for the original, volatility-based indicators that he presents in the book. With these examples in hand, any trader can apply the concepts which are explained in rich detail. Northington’s goal seems to be to teach the reader how to build indicators based upon unique market insights; test the indicators on a stand-alone basis; and incorporate meaningful indicators into trading methods that suit a trader’s personality. In doing so, he also provides a ready-to-go trading system that can be applied with days of beginning the book.

Kirk Northington is the owner of Northington Trading, LLC, and the creator of MetaSwing, a MetaStock Add-On and TradeStation-compatible system. He trades his own money, and uses the technical analysis methods presented in this book exclusively. He is an associate member of the Market Technicians Association, through which he is participating in the Chartered Market Technician (CMT) Program. Kirk has a B.S. degree from Nicholls State University, in Thibodaux, Louisiana. He has extensive experience in control system engineering, software engineering, and project management. Kirk, his wife Faith, and his two sons live in Charlotte, North Carolina.