The Nature of Trends

Strategies and Concepts for Successful Investing and Trading

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Contents

Acknowledgments

My gratitude is on four levels. The first level is personal—to the folks that made it all worthwhile; without their many contributions to my life, this book would never have been written.

A big "thank you," as always, to my wife, Christine Kwan-Barros, who has stood by me loyally as I have learnt my craft and is still by my side, despite the trials and tribulations of our 37 years of marriage. My heartfelt thanks, too, to my parents, Rosario and Frankie Barros, for their unstinting selflessness while raising their eight children. I wish Dad had been alive to read this book.

The second level of my gratitude belongs to my teachers, both direct and indirect. Peter Steidlmayer's books and seminars put me on the road to successful trading. His influence permeates my trading, as does the work of Richard Wyckoff.

Joseph Hart also deserves special mention for his ideas on the Whole Point Count and Line Change Count.

Now to the third level: I wish also to thank all the students who enrolled in my course, *Successful Trading Concepts*. In the process of teaching them, I too became a student.

And finally, to the fourth: Robyn Flemming, my editor. Without her efforts, this would have been a much lesser work. Thanks, Robyn, for all your assistance!

Introduction

The trader today has assistance that the traders of old would have given their right arm for; certainly, *I* would have. They have unheard-of computing power, and the benefits of the gigantic leaps made in the study of neurology, decision making, psychology, and learning. Thanks to Neuro-Linguistic Programming, we now have the tools to model success.

But the sad fact remains that the ratio of financial successes to losses is not too different from when I placed my first order. Anecdotal evidence suggests that 80–90% of traders consistently lose money. Part of the problem is the computer. Computing power is both a blessing and a curse. It's a blessing in that statistical power is now available to all—thus providing the opportunity for better risk management. It's a curse because it has led traders away from the search for the principles that underlie market action, to a search for "angles" that are profitable but which have a "use-by" date. The black joke is that no one has told the newbie trader of the difference between the two. Nor has he or she been told why that difference is important.

What is an "Angle"?

Peter Steidlmayer called angles "behavioral parameters"—patterns that will make money as long as not too many traders use them. The market, being a complex, self-adapting system, renders angles ineffective (that is, they lead to a loss of your trading dollars) as soon as too many traders use them.

In the early days of *Market Profile*, there was a behavioral parameter called the "Value Area" rule. This rule stated that if on a rotational day—that is, a day that moved from high to low, low to high, as distinct from a directional day—the market accepted prices below the "Value Area," there was an 80% probability that the market would go to the opposite boundary.

Well, for a while it was money for jam. But then the word spread and . . . I remember one day seeing this angle set up in the Australian 10-year bonds. The only problem was, this time, the next trade after the market accepted below the "Value Area" was at the opposite end! Yes, it was a particularly thin market, but from that day the hit-rate for this angle dropped for that instrument.

Another reason for the lack of success is the nature of the newbie trader. Until he learns that the market does bite, he believes that success is easy. After all, he can see the chart points for himself, can't he? It's so easy! *Here's the high, sell it; and there's the low, buy it!* And there's enough hype "out there" to reinforce this fantasy. Sure, he's heard the stories about the high failure rate, but that won't happen to *him*. It's strange that the newbie wouldn't dream of performing surgery without first undergoing years of medical training, while at the same time believing that all he needs to succeed in trading is money and courage.

Trading is a profession where the road to success is both difficult to follow and yet simple to pursue. It's hard because the application of the rules of success runs contrary to our nature; it's simple because the map to success has been clearly laid out.

Is there a solution? There is, and that is to think in terms of principles. My goal in *The Nature of Trends* is to explain the principles, or trading concepts, that have worked for me, and to relate those principles to the elements of a discretionary trading plan. Those elements are:

- Identify the trend, and where the market is located within the trend. Once you determine that, you have your strategy—that is, whether for this trade you are to be a buyer or a seller.
- With your strategy decided, you are ready to look for a low-risk entry. Five elements comprise low-risk entry:
  - *Zones:* for a responsive trader (a buyer on dips in uptrends; a seller on rallies in downtrends), zones are support (uptrend) or resistance (downtrend) areas that contain the correction.
  - *Setups:* chart patterns that provide confirmation that a zone is holding.
  - *Entry patterns:* chart patterns that confirm the zone has held and the trend resumed.
  - *Initial stop:* the cut-loss method based on time or price.
  - *Risk/reward:* the money management calculation that says there is value in the trade.
- Once you are in a trade, it's time to focus on trade management—how to exit profitably.

In short, *The Nature of Trends* considers the questions: *What is the trend?* And *Will it continue or change?*

I am inevitably asked: "If you're so successful as a trader, why do you . . . ?" My answer is a straightforward one. Each of us has four main desires:

1. *To live*: We all want a life that we envisage we would enjoy, including all the material trappings that life can bring. I have been lucky enough to experience that and more.
2. *To love:* We all want to have had the opportunity of loving and being loved; of being, for the person we love most in the world, the most important person in the world in return. Again, I have had that good fortune.
3. *To learn:* My parents taught me early that learning is a never-ending experience, and that it's up to each of us to be all we can be. I have never stopped wanting to learn.
4. *To leave a legacy:* This is one goal I haven't yet achieved, despite my best efforts. Perhaps this and future books will be my legacy. We'll see.

Outline of The Nature of Trends

Chapter 1 introduces my beliefs about trading success and about what is needed to reach your goals. It then describes a model of the market's structure, before concluding with a discussion of the Barros Swing and its relationship to the three trends—up, down, and sideways.

Chapter 2 discusses the change in trend patterns. Chapter 3 deals with the idea of "acceptance" and the function and impact of time frames. Chapter 4 looks at derivative indicators. Chapter 5 examines some of the important aspects of entry and trade management. Chapter 6 examines three instruments, and tracks a trade to illustrate the concepts explained in the book. Finally, the appendix explains how the Barros Swing is constructed, as well as Steidlmayer's method for calculating standard deviations—an approach quite different from statistical theory.

Chapters 1 to 5 begin with a pictorial road map that outlines the contents of the chapter.

One final, important point: **To facilitate your reading, some figures are duplicated so that you don't have to turn the page to find the chart to which the text is referring**. This is a novel approach. Please let me know if you have found it a useful innovation.

I welcome any queries on the construction of the Barros Swing. Send your enquiries to: ramonbarros@mail.com or visit www.tradingsuccess.com.

CHAPTER 1

Definition and Identification of Trends

Welcome to *The Nature of Trends*. My desired outcome for this book is a simple one: that it be the vehicle that will enable you to achieve your financial goals. But I must admit that I do harbor doubts that this outcome will be achieved. The reason? Its attainment lies as much in your hands as it does mine.

So, let's make a deal: treat this book as a manual for your success. Don't just read it; study it, and integrate the ideas contained in it into your psyche through practice, and more practice. In return, I promise you that your trading will scale new heights. I know this, because many have gone before you and if the ideas set out here worked for them, why not for you?

INTRODUCTION

Modern learning theory says we learn best when we have a sense of where the text is leading us. The pictorial road map depicted in Figure 1.1 shows:

1. In this chapter, we will look first at my beliefs about the relationship between trading success and the nature of the market.

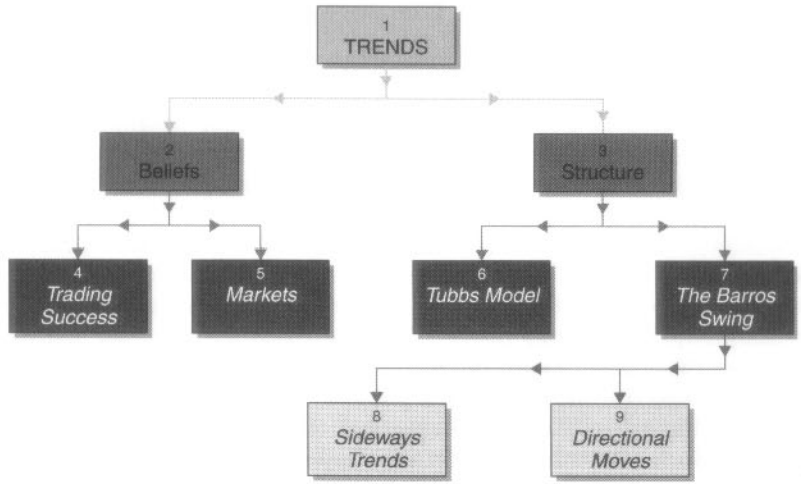


FIGURE 1.1 Pictorial Road Map of Chapter 1

2. We will then take an in-depth look at the structure and nature of trends.
3. Finally, we will see how the Barros Swing helps us identify not only the nature of a trend, but also its time frame.

MY BELIEFS ABOUT THE RELATIONSHIP BETWEEN TRADING SUCCESS AND THE NATURE OF THE MARKET

Neuro Linguistic Programming, the psychology of modeling success, tells us we model success by replicating three aspects:

- beliefs;
- states; and
- mental strategies.

The key to understanding my approach to trading is to understand each of these components and the way they interact. We will examine each concept as we proceed through the book. For now, let's take a glimpse at some of my beliefs—first about trading success and then about markets.

My Beliefs about Trading Success

Trading success has proven elusive for most market players. When I first joined the game in the late 1970s, the focus was on having the right plan; then money management was all-important; lately, psychology has taken center stage. Yet, as the following formula illustrates, all three elements are essential if we are to attain our trading goals.

Winning Psychology × Effective Money Management

× A Trading Plan with an Edge = Trading Success

How do these elements assist the trader? As traders, our psychological state, or mental mind-set, can lead to consistent profitability; our money management ability determines the size of our position and bet size; and our trading plan delivers the edge, defining how and when that edge occurs. We won't be dealing with psychology and money management in this book. Instead, we will focus on the trading plan.

A plan represents the means of weaving a path through the jungle that is the markets. There are as many successful plans as there are individual personalities. What is important is that the plan and personality form a whole. Since the plan needs to fit the trader's personality, traders have the option of using a fundamental or a technical approach. If we adopt the latter, we are faced with choosing between a mechanical approach and a discretionary one. As the differences are important, let's consider them now before we go any further.

The Mechanical Trading Approach

The mechanical trading approach has the following characteristics:

- The mechanical trader seeks to exploit "angles"—or, as Pete Steidlmayer called them, "behavioral parameters." These market patterns deliver profits over a large sample size but have a use-by date. We'll examine why in the next section.
- A mechanical method generally ignores the context of a trade.
- Generally, the mechanical trader limits his or her plan's inputs to a maximum of three. (Some mechanical traders seek to optimize the inputs on an instrument-by-instrument basis, but I believe that the more robust plans have the same variables across markets and time frames.)
- The mechanical trader exercises his discretion and creativity at the design stage of his plan. Once the plan is formulated, the mechanical trader will "see a trade, take a trade"; in other words, he will take every trade that meets his plan's criteria; he'll take every trade irrespective of how he feels about its "correctness"; he'll take every trade simply because his plan calls for the trade.

The advantage of the mechanical trading approach is that we learn to execute consistently. We take every trade, without hindering our execution with fear or hope.

The Discretionary Trading Approach

The discretionary trading approach has the following characteristics:

- The discretionary trader usually has a model of markets that accords with reality; in other words, his holistic plan has an edge. This advantage is a result of a set of beliefs that represents market behavior sufficiently well to deliver profits over time.
- The discretionary trader adopts a model that is based on principles or laws that are enduring. Examples of discretionary traders include: Richard Wyckoff, Charles Drummond (P&L Dot), Peter Steidlmayer (Market Profile), George Soros (Reflexity), and Joseph Hart (Trend Dynamics). These traders span a period of almost 100 years. While their theories and models may differ, they have in common a number of basic principles that remain true today. One common principle running through all the models is "context." The context in which an event occurs is of extreme importance to the discretionary trader. For example, the DOJI is a pattern that suggests balance. (In this chart pattern, the open and close are in about the same place; often the range of the bar is smaller than normal.) After a directional move, a DOJI may signal a change in trend, or at least a correction. On the

other hand, a DOJI appearing in the middle of congestion has little probative value. A subjective trader will consider where the DOJI occurs—for him, context is everything. When he sees a DOJI, he considers the context and then proceeds to draw certain conclusions. The mechanical trader is less likely to ask about the context in which the DOJI appears.

- The discretionary trader may not take a trade just because the plan calls for it. How he feels about the trade is also important, as are other areas of discretion, such as position size, bet size, and the relative importance of various variables. In other words, both the right brain and the left brain need to align.
- Whereas the objective trader limits the inputs to no more than three, the discretionary trader may revel in a much larger array.

The advantage of the discretionary trading approach is that it mirrors the fluidity of the market, and we therefore expect the competent discretionary trader to have a better risk/return ratio than the competent mechanical trader.

Those are my beliefs about success. Now, let's examine my beliefs about the nature of markets.

My Beliefs about the Nature of the Market

Sir Isaac Newton's natural laws have been overturned by the theory that governs any free market, Complexity Theory—where "certainty" has been replaced by "chaotic probability." While a detailed examination of this fascinating theory is outside the bounds of this text, we need at least to mention the tenets that apply to the markets:

- There is order behind the apparent randomness of the markets.
- This order is fractal in nature—that is, we see the same patterns in all time frames, from the lowest to the highest.
- We can determine the probability of an occurrence over a large sample size, but we are unable to determine the result on an event-by-event basis. Mark Douglas identified this critical paradox. On a trade-by-trade basis, the market is uncertain and unpredictable; yet, over a large sample size, it is reflectively certain and predictable.
- Complex systems are self-learning. This characteristic explains why mechanical "angles" have a use-by date.

These tenets have important implications for both the mechanical and the discretionary trader. For the discretionary trader, they dictate the starting point for his model; that is, they define his view of the structure of the market. A trading structure needs to follow the basic tenets of the theory. And my model does just that, despite my not having heard of Chaos Theory or Complexity Theory when I first adopted it.

Let's look at the structure I adopt. It's a classic one, and has been around since *Tubbs' Stock Market Correspondence Lessons* (1941).

THE STRUCTURE OF THE MARKET

The Tubbs Model

The Tubbs Model, shown in Figure 1.2, gives the trader a road map of market activity as it proceeds from an uptrend to a downtrend, from downtrend to uptrend, and so on. As internalizing its characteristics puts the probability of success in our favor, let's review its essential traits.

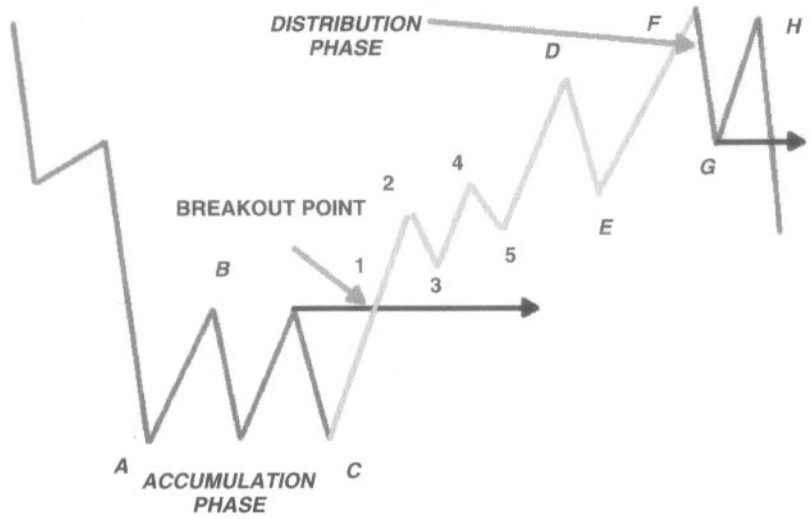


FIGURE 1.2 The Tubbs Model

After a prolonged bear market, there is a period of accumulation. Figure 1.2 marks this period *A*/*B*/*C*. At 1 we have a breakout and the first confirmation that a new bull market may begin. The breakout point is a bifurcation point in Complexity Theory—at 1 the market can either confirm the new bull trend or re-enter congestion.

Once the bull market gets under way, we can divide its movements into three sub-structures: up moves; down moves; and sideways, or horizontal, moves.

- The up moves gain more ground than the down moves. In an uptrend, the up moves are called an "impulse," while the down moves are called a "correction." In Figure 1.2, waves 2, 4, *D*, and *F* are impulsive, and waves 3, 5, *E*, and *G* are corrective.
- Similarly, in bear markets, down moves are "impulsive" and up moves are "corrective."
- Moves that make no new ground and merely oscillate around a central price are called sideways, or horizontal, trends. In sideways trends, highs and lows are about equal.

In short, we can say that bull trends are characterized by higher highs and higher lows, bear trends by lower highs and lower lows.

The fact that markets are fractal means: (1) we observe similar patterns in all time frames; (2) the shorter the time frame, the more likely it is to be affected by "shocks"—that is, by surprises that cause the market to experience temporary disequilibrium; and (3) the higher time frames control the lower ones, as follows:

- at critical turning points—that is, when the higher time frame changes its trend; and
- by the next higher time frame's nature—that is, the higher time frame trend will affect the magnitude of the impulse moves and corrections of the lower time frame. This concept will become clearer when we look at the Ray Wave.

That's the long and the short of it. Combine the visual road map in Figure 1.1 with the points just covered and you have a generic outline of all market activity.

Is that all we need for success? Well, not quite. Among other essentials, you need a written trading plan.

A discretionary plan has certain elements:

- *Trend:* Trend, change in trend, and *where we are* in the trend.
- *Low-risk entry:* Zones, setups entry, and initial stop.
- *Trade management:* Profit-taking strategies and trailing stops.

The first step, then, in writing a trading plan is to have some way of defining the trend of a time frame. I use Barros Swings to define trends and time frames. Let's now turn to that subject.

A Model for Defining Trends and Changes in Trends: The Barros Swing

A Barros Swing is a swing chart. Swing charts identify support and resistance points of certain magnitudes. Sometimes these magnitudes are determined by time—for instance, a three-period Gann Swing Chart; sometimes they are determined by price—for instance, Arthur Merrill's filtered waves (price percentage swing charts). Barros Swings are unique in that they incorporate both time and price in the formula. The formula is stated in the appendix.

Barros Swings help me identify not only the nature of a trend, but also its time frame—that is, they define the trend of a time frame and tell me when a change in trend has occurred. I do this because, usually, trading with the trend increases the probability of a successful trade. Think of it this way: statistically, strapping on my safety belt when going for a car journey means I have a better chance of surviving an accident. Similarly, when trading with the trend, I am trading in the direction of least resistance. This means I have a greater edge and, thus, a higher probability of making money.

Too often, novice traders confuse getting lucky with being good traders: they get lucky when they luck into a strong trend. And, while that trend continues, they believe they are "good traders" when they are in fact acquiring habits that will destroy their trading careers. In the 1992–1999 NASDAQ uptrend, I had close friends who bought willy-nilly. If the market went against them, they held their positions; some even added to them. They felt that considerations of trade management, risk, and money management were only for the faint-hearted. Needless to say, when the market turned down in 2000, they lost all they had made.

The first step in adopting a risk-averse approach to trading is to identify the trend of a time frame. But this is easier said than done. Most technicians use moving averages to identify the trend. But I have a problem with this tool: moving averages treat *corrections against the trend* as *changes in trend*. So, at the very time we ought to be looking to buy in an uptrend, the moving average is calling for us to sell.

To overcome the shortcomings of most technical analysis trend tools, I turned to swing charts. In the remainder of this chapter, we will examine how the Barros Swing helps us identify not only the nature of a trend, but also its time frame. We will look at:

- using Barros Swings to define the trend;
- using Barros Swings to define changes in trend; and
- the construction of Barros Swings.

BARROS SWINGS AND TREND DEFINITION

Bread and butter, knife and fork . . . some words just go together. *Trend* and *time frame* should also be linked together in our minds. When asked: "What is the trend of instrument 'X'?", my response is inevitably: "Over what time frame?"

The tool that we'll now consider identifies both the time frame and its trend. Let's look first at the time frame.

- The 5-day swing identifies the weekly trend.
- The 18-day swing identifies the monthly trend.
- The 13-week (60-day) swing identifies the quarterly trend.
- The 12-month (250-day) swing identifies the yearly trend.
- The 30-month swing identifies the 2.5-year trend.
- And so on.

Identifying the time frame is half the job; the other half is identifying the trend of the time frame. There are three types of trends:

- sideways;
- uptrends; and
- downtrends.

Sideways Trends

Also known as "horizontal trends," the highs and lows of sideways trends are about equal. Figure 1.3 shows an uptrend, with X/A being the last impulse leg. A, B, C, and D then form, with C/D having about the same highs and lows as A/B. The figure also shows the following characteristics of a horizontal trend:

- There are clearly delineated boundaries. In Figure 1.3, A and B mark the boundaries.

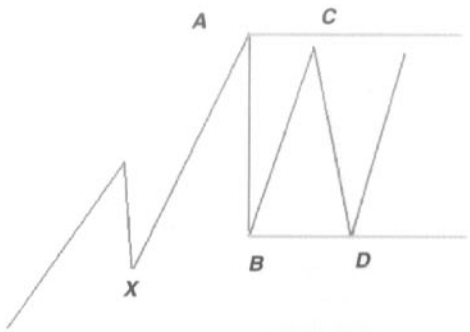


FIGURE 1.3 A Sideways Trend: I

- The market may move above A and below B. But as long as they remain within certain boundaries and return to the area of congestion (the area within the limits of the sideways trend), the pattern remains a congestion pattern.
- If the market retraces less than 78.6%, it will probably continue away from its originating boundary. Figure 1.4 illustrates this principle: the originating boundary of C is A; C/D is less than 78.6% of A/B; consequently, E will probably turn down and head toward B. I have drawn a dashed line, E/F, to represent this idea.

Beyond the boundaries of congestion (that is, the limits of the sideways trend), we can assume that the market has resumed its directional move. Clearly, then, it is important to define and quantify the conditions under which we'll say that the directional move has resumed. I call these boundaries the "maximum extension." Figure 1.5 shows the normal limits of expansion (maximum extension).

One limit is 10% of the impulse move X/A added to the high of A (in an up move) and subtracted from the low of A (in a down move). There is a qualification

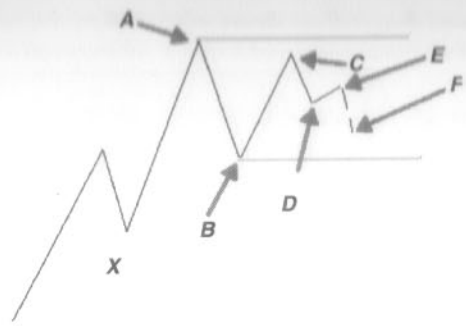


FIGURE 1.4 A Sideways Trend: II

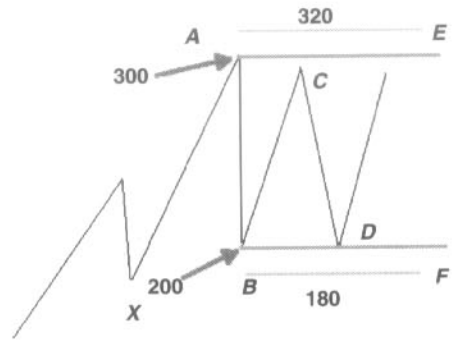


FIGURE 1.5 Maximum Extension in a Sideways Market

that X/A must be at least equal to an average impulse move (that is, at least equal to the impulse mean). If not, then we move X back one low or more lows until X/A is at least impulse mean.

As a trader's mentor, I found that many novice traders were reluctant to calculate the impulse means, considering it a "tedious" process; instead, many chose to "eyeball" the average. Hmm... I can tell you that, for their bottom line, this proved to be a dangerous practice. So, I came up with a calculation that gives us about the same result. Nowadays, I use the larger of both calculations to give me a maximum extension range. You can use the second calculation only if you are confident that the boundaries of congestion are relatively accurate.

This second formula, and easier calculation, is: *20.0% of the boundary extremes.* In the example shown in Figure 1.5 above, let's say A/B is 100 points, the price at A is 300, and at B it's 200. Twenty percent of A/B is 20 points. Hence, E would be at 320 (300 + 20) and the line F would be at 180 (200 − 20).

Because markets do expand the boundaries, I find it useful to re-label the boundaries of congestion. Figures 1.6 and 1.7, and the accompanying text, illustrate the re-labeling process.

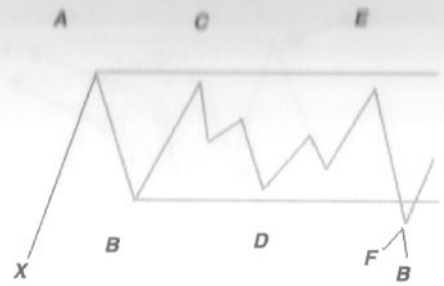


FIGURE 1.6 The Re-labeling Process

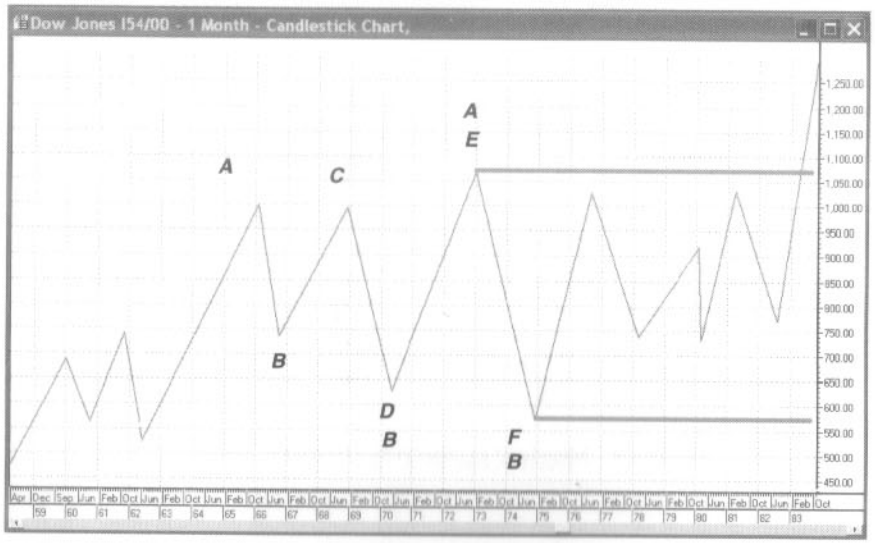


FIGURE 1.7 Dow Jones Industrial, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

In Figure 1.6, *A* and *B* mark the boundaries of congestion until *F*. At that point, there is a false breakout to the downside, thereby extending the *A*/*B* range. (By "false," I mean the market broke down only to return to congestion.) I find it convenient to re-label *F* as the new *B*. This enables me to keep the boundaries of congestion clear and simple.

The next example (Figure 1.7) is from the monthly price action of the Dow Jones Industrial Average (DJIA) between 1962 and 1983. Let's see what the charts tell us.

- At *C*, a possible trading range forms. *B* fails to hold, and the Dow has a false breakout at *D* when *B* low is breached at *D*, **but** the market returns to congestion. *D* is re-labeled *B*.
- At *E*, the Dow has another false breakout when *C* is breached, **but** the market returns to congestion. *E* is now labeled *A*.

- At *F*, the Dow has another false breakout. The new low is re-labeled *B*. The boundaries delineated by *A* and *B* hold from 1975 to 1983.

At this point, let's review what we have learnt so far: The Barros Swing defines the trend of a specific time frame. We have defined uptrends, downtrends, and horizontal trends. We have also considered the characteristics of horizontal trends and my process of labeling.

The next aspect I want to consider is horizontal trend formation. But before we do that, let's take a breather. Whew, all that content can be quite overwhelming, can't it?

The reason I am taking pains to identify and label sideways markets is because they occur far more frequently than trending markets. Now, that would be okay if the strategies we employed for the two types of trends were the same. But they aren't. In a trending market we can play "go-with"—that is, in an uptrend buy every new high and/or every correction; and in a downtrend, sell every new low and/or every correction. However, in a sideways trend, the "go-with" strategy will probably lose you money; more importantly, you'll do much better if you "fade" a move around the boundaries of congestion. (By "fade," I mean you "sell highs" and "buy lows," rather than "buy new highs" and "sell new lows.")

Let's turn now to the formation of horizontal markets.

Formation of Horizontal Markets

Horizontal markets generally form in one of three ways.

The Normal pattern

The Normal pattern is shown in Figure 1.8. Once the market fails to make a new high at *C* and turns down, potentially a congestion market is forming.

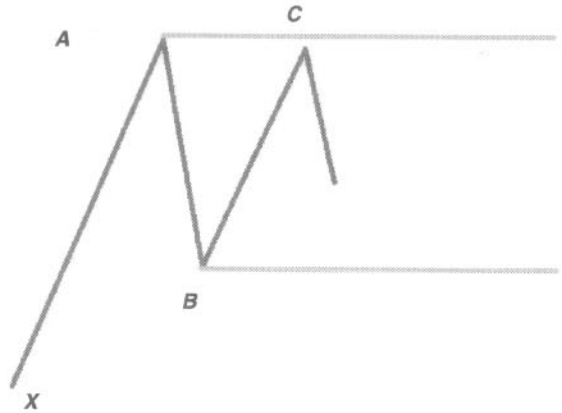


FIGURE 1.8 The Normal Pattern

You'll find that the deeper the retracement of X/A by B, the greater the possibility that a sideways market will form at C. In fact, if B retraces X/A by 78.6% or more, the probabilities favor a congestion market forming at C.

The Breach of Support or Resistance pattern

The Breach of Support or Resistance pattern is shown in Figure 1.9. Here, C exceeds A (resistance) by less than the 10% of X/A/20% of A/B range. (That is, the market breaks above the boundaries of congestion but stays within the maximum extension.)

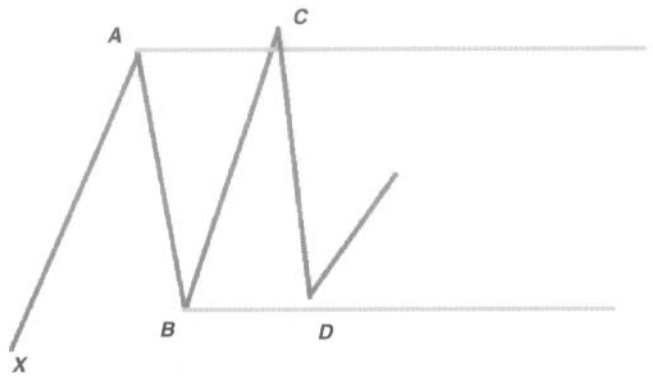


FIGURE 1.9 The Breach of Support or Resistance Pattern

It is IMPORTANT that the market turns up at D. If not, we can expect it to evolve into a change in trend pattern. Indeed, as we will see, this pattern is a very reliable change in trend pattern. So, when I see this pattern form in my trading time frame, it's an indication that a change in trend is in progress, and not a congestion. It is IMPORTANT to distinguish between the two, because your strategy will be different. If congestion is in progress, we would sell the new high at C in Figure 1.9. The failed breakout at C suggested a change in trend; it is only when the line turns up at D that the probabilities reverse and turn from favoring a change in trend to favoring congestion.

What do we mean by "support" and "resistance"? Let me quote from the very first book I read on technical analysis, Edwards and Magee's *Technical Analysis of Stock Trends*, 5th edition (Boston: John Magee, 1983), p. 211:

> A *support* level is a price level at which sufficient demand for a stock appears to halt a down trend temporarily at least, and possibly, reverse it, i.e. start prices moving up again. A *resistance* zone, by the same token, is a price level at which [there is] sufficient supply ... to stop, and possibly turn back, its up trend... [A] support range represents a concentration of *demand* and resistance range represents a concentration of *supply*.

By "demand," the authors meant "buyers"; and by "supply," they meant "sellers."

A corollary rule is: once prices accept below support, support becomes resistance; once prices accept above resistance, resistance becomes support.

An aside: I had assumed that students enrolled in my mentor course knew the meaning of "support" and "resistance"—until one of them set me straight. I had fallen into the greatest trap awaiting the discretionary trader when dealing with trend determination: I had made an assumption.

We make assumptions about trends based on our experience, level of knowledge, and the information available; in short, we make the best decision possible in the circumstances. However, the danger is that we continue to hold assumptions despite new clues and/or fresh evidence to the contrary. As a discretionary trader, my success depends on my continual examination of the terrain for information that challenges my assumptions.

We now turn to the last pattern in the series: the "surprise."

The Surprise pattern

The Surprise pattern is shown in Figure 1.10. At C, we expect the uptrend to continue. Instead, the market breaches the low at B, signaling the possibility of congestion forming. For this pattern, it is important that the market breaches A and that it retraces at least 78.6% of C/D before it turns down (E).

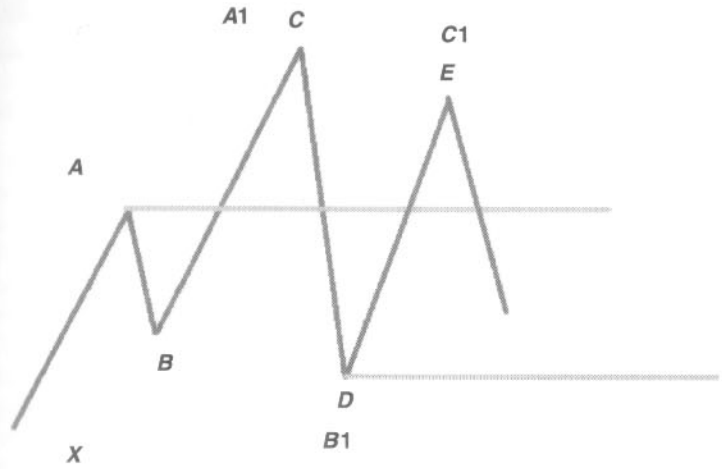


FIGURE 1.10 The Surprise Pattern

Notice that I have re-labeled the completed pattern with $A1/B1/C1$. Viewed in this light, we have a Normal congestion formation. So, if in its final form a Surprise takes the form of a Normal pattern, why create a separate category?

Because, unless we recognize the Surprise process, we are likely to misinterpret the type of trend when the market breaches *B*.

Congestion markets give rise to strategies different than those we employ in uptrends and downtrends. I have learnt from experience that, in the absence of evidence of a change in trend, a market will exit congestion in the same direction as it entered. Consequently, unless I have evidence of a change in trend, within congestion I initiate positions only in the direction of the previous directional move.

So far, in congestion, we have covered formation, nature, and strategy to employ. Before we turn to the other two types of trends, uptrends and downtrends, let's apply what we have learnt so far.

In Figure 1.11, the market approached the old high at *A* and turned down at *C*. This tells us that congestion is probably about to form. As a result, we would be on the lookout for a buy around *B*: between the 78.6% retracement level of *A*/*B* and the maximum extension. The list that accompanies Figure 1.12 explains what occurred.

- The maximum extension came in at 0.6524.
- The 78.6% retracement area of the boundaries of congestion was *A*/*B*.

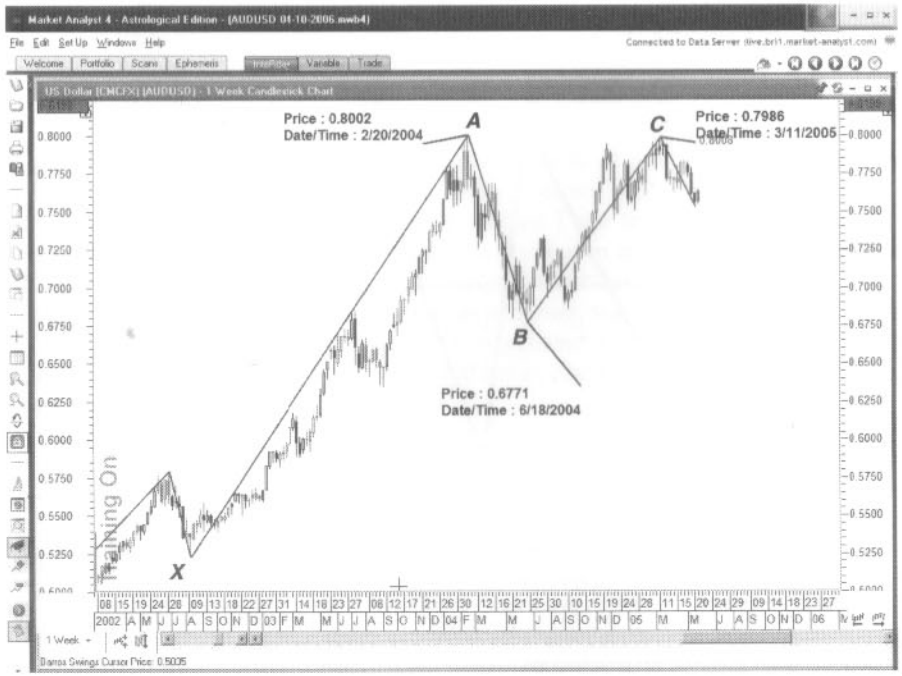


FIGURE 1.11 Weekly ADUS Congestion Formation: I
Source: Graphics used with permission from *Market Analyst*.

FIGURE 1.12 Weekly ADUS Congestion Formation: II
Source: Graphics used with permission from *Market Analyst*.

- The market dropped to the 80% retracement area and turned up. At the time of writing, it had broken above the upside maximum extension at 0.8248.

When I first started trading, I failed to appreciate the importance of identifying sideways markets and the need for different trading strategies for congestion markets than for trending markets. One event is imprinted in my memory. It was a Friday and I'd had a pretty good week of day trading. Chrisy, my wife, suggested I give trading a miss that night because I looked like a "car with no petrol in the tank"; and truth be told, I *was* tired. But hey, hubris set in and I figured I could rest on the weekend. Well, the S&P didn't do too much that night. My journals say it had a 6-point range. But my equity sheet showed I managed to lose 39 points! I succeeded in buying every high and selling every low.

It was only after my first workshop with Pete Steidlmayer on the Market Profile that the pennies started to drop. So, guys and gals, learn the lesson well.

Let's move on to trending markets.

Directional Moves: Uptrends and Downtrends

Uptrends have higher highs and higher lows; downtrends have lower lows and lower highs. The question arises: How many higher highs for an uptrend and

how many lower lows for a downtrend? I prefer to see at least two higher highs for an uptrend and two lower lows for a downtrend. For an uptrend, if I see only one higher high and higher low, I rate that as only a "potential uptrend." Naturally, in a downtrend, I want to see at least two lower lows; one lower low, lower high . . . I rate a potential downtrend. This is a general principle that I may modify, depending on the context. For example, if the market has been congesting for some time, I am more inclined to accept a breakout.

Figure 1.13 shows the Dow as it broke out of its multi-year congestion in 1984. *All swings within A/B are inside swings and can be discounted.*

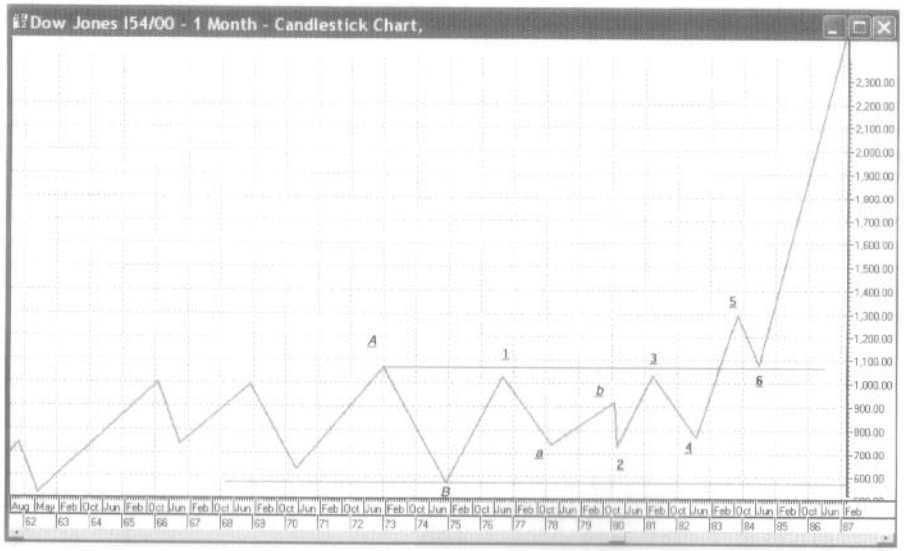


FIGURE 1.13 Dow Jones Industrial, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

At 5 we have the breakout, followed by the classic re-test at 6 of the breakout level. At the re-test at 6 I would have rated an uptrend as probable.

In Figure 1.14, we have a weekly chart of the Dow in its 2003 breakout after 35 weeks of congestion.

I would rate this breakout only as a *potential* uptrend. We have one higher high, and a higher low is still to form. In addition, the first eight weeks of the breakout resulted in a one-week sideways move. Finally, even after the one-week uptrend commenced, the gains haven't been in keeping with a move preceded by a 35-week congestion.

What do I mean by a one-week sideways move? I mean that a Barros Swing of a one-week magnitude defines the sideways move.

The swings in Figure 1.15 are of a one-week magnitude. I have defined the congestion after the breakout with the labels 1/2 and have drawn in the horizontal channels. The chart is current to date of writing, and I believe the price

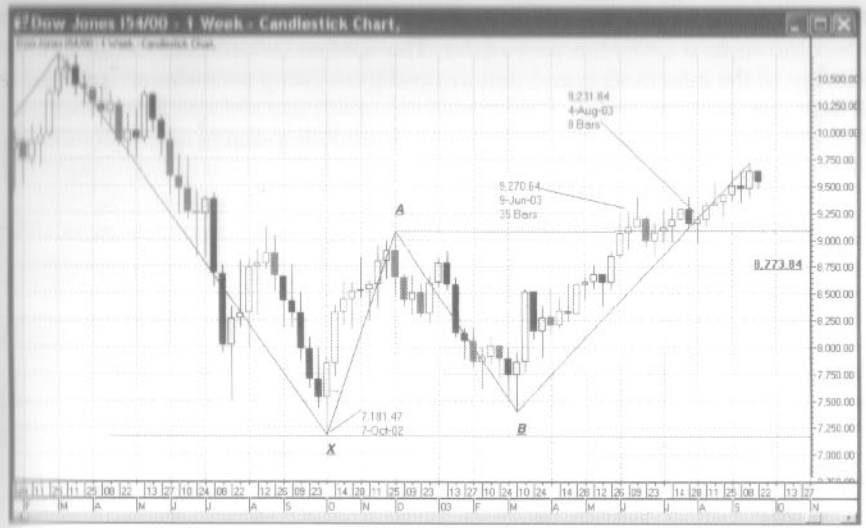


FIGURE 1.14 Dow Jones Industrials, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

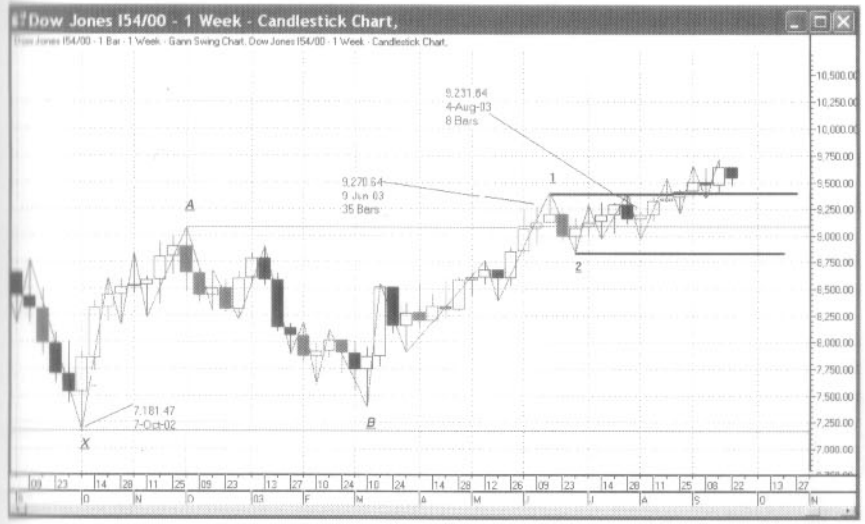


FIGURE 1.15 Dow Jones Industrial, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

action suggests at least a 13-week swing retracement to *A*, if not a return into congestion. Fresh information, as it becomes available, will confirm, vary, or reject this view.

The comparison of the Dow breakout in 1984 and 2003 has served to illustrate what I mean by "a general principle modified by its context." For a discretionary

trader, market information, chart patterns, and so on, must always be examined against the context in which they occur. The context determines the value and reliability of the information and pattern, and in so doing provides an invaluable risk management tool.

One aspect of context is the differing strengths of uptrends and downtrends, and we shall turn to that topic next.

Differing Strengths of Trends

Within uptrends and downtrends, the directional moves vary in their impulse strengths.

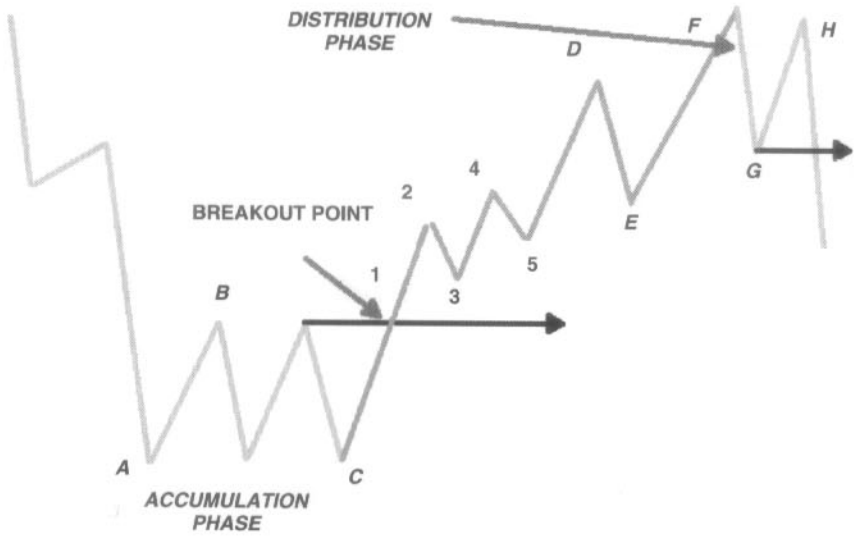


FIGURE 1.16 The Tubbs Structure

The Tubbs Structure (introduced earlier in the chapter and repeated in Figure 1.16) illustrates this concept. The impulse structure labeled *A*/*B* is an impulse move of subnormal strength. The impulse move from *C* to 2 is a move of abnormal strength; finally, the move from 5 to *D* is one of normal strength.

Classifying impulse moves helps us fine-tune our strategy, as the different types have their own unique line of attack.

- A subnormal move requires patience, as we adopt a "buy on retracement" approach.
- A normal move will accommodate both a breakout and a retracement policy.
- An above-normal move is best served by breakout trading.

The key question of course is: How can we identify the strength of a move in order to be able to take advantage of it? To answer this question, we'll use the

characteristics of each strength type. But, before we turn to this subject, a word of warning. This section relies on the reader having a passing acquaintance with statistics. If you are unfamiliar with the subject, an excellent primer is Derek Rowntree's *Statistics Without Tears*. It's a short book and relatively inexpensive. I consider any trader trading without at least a passing acquaintance with statistics as trading without an essential and invaluable tool.

I will also be introducing the concept of wave structures: I'll introduce the basic ideas that impulse moves are either three-wave or five-wave affairs, and that each wave structure has its own characteristics.

Subnormal Moves (R0)

I give these moves a Ranking 0, as I consider their profit potential to be low—unless you learn to identify them early. To classify the moves, I look at the following:

- The strength of the first lower time-frame moves—whether the impulse moves are average, below average, or above average. In R0 structures, *the impulse mean of the trader's time frame (i.e. the time frame you are trading) will be below average.*
- Another clue that an R0 is forming is when the first lower time-frame impulse line turns are below average. For example, in a 5-day up-move, *the 18-day impulse move will be below mean and the 5-day impulse moves will be less than average.* (A 5-day impulse move usually comprises more than one 5-day impulse move.) In Figure 1.17 we have a 5-day impulse move commencing October 10, 2002 and ending on December 2, 2002. After the

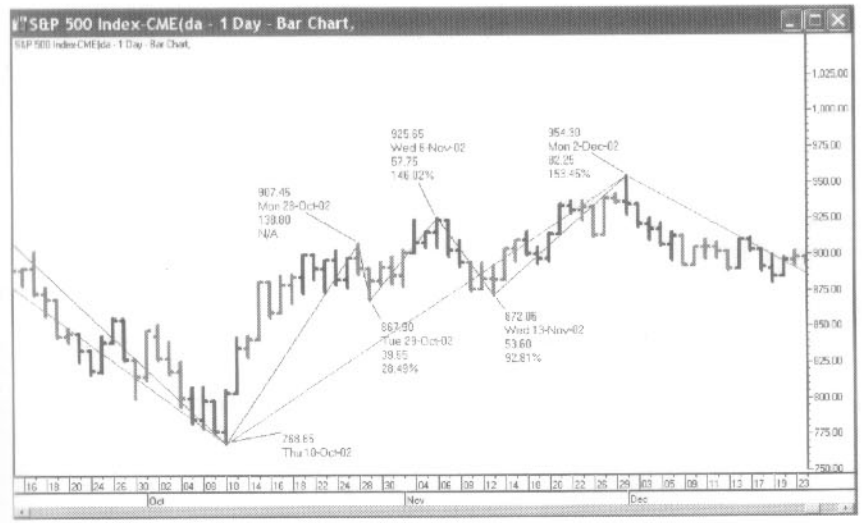


FIGURE 1.17 S&P, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

5-day line turned down, we find that the impulse move is below average. Were there any moves that indicated this may be so before the 5-day turned down? The first 5-day move—from October 10, 2002 to October 28, 2002—is mean. However, the two succeeding 5-day moves are below average, giving us a clue that the 5-day impulse move will also be below average. So, the impulse moves of the first lower time frame may provide an indication of how strong we can expect the trader's time-frame trend to be.

- Another clue is the structure and line of the first higher time frame. If that is weaker than normal, then we expect the impulse move in the traders' time frame to be an R0. The traders' time frame is the one that defines the trend, and therefore the strategy to be employed.

A question that arises is: What characteristics can we expect from an R0 trend? If the first impulse move is below average, you will have the first characteristic of an R0 pattern; the second is the deep retracement that usually follows. By "deep retracement," I mean a retracement that exceeds 67% and up to 100% of the preceding impulse move. Finally, an R0 structure is composed of four waves or six waves. In a six-wave pattern, wave-6 may be shallow retracement only—that is, it need not *necessarily* retrace more than 67% of wave-5. Figures 1.18 and 1.19 show four- and six-wave patterns, respectively.

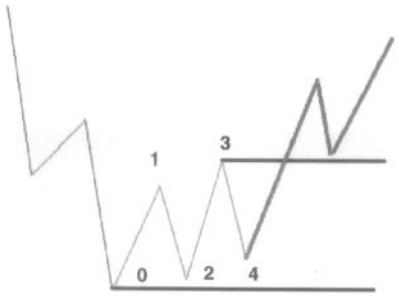


FIGURE 1.18 R0 Four-wave Pattern

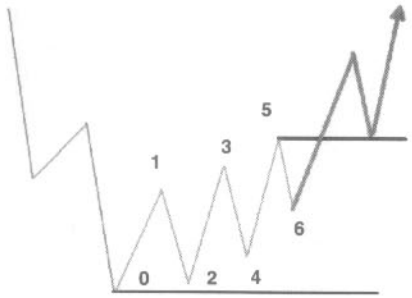


FIGURE 1.19 R0 Six-wave Pattern

Figure 1.20 shows a further characteristic of the six-wave structure: if the move fails to reverse the previous trend, we can expect wave-1 of the new move to be above average.

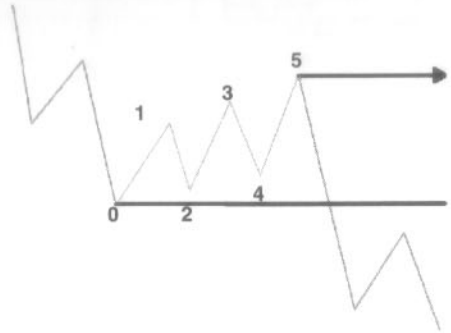


FIGURE 1.20 Failed R0, Six-wave Pattern

Once we have identified an R0 structure, our next step is to evaluate its effects. The effect of an R0 structure depends on where it occurs. If it occurs as the first pattern of a bull market, its presence is bullish; if it occurs as the third or fifth pattern, its presence is probably bearish.

Normal Impulse Moves (R1)

I call these moves "normal" because they represent 40% to 68% of impulse moves. The normal has an important characteristic. If the impulse swing on a breakout from congestion is mean, don't expect the retracement of 40% to 68%. Generally, the market will only retrace back to the breakout point *provided that* at the time of breakout the market forms a wide-range breakout bar.

A wide-range breakout bar has the following characteristics:

- It has a range and volume that is above normal.
- In an up bar, the open forms no higher than in the bottom third of the range (and preferably in the bottom quarter), and the close is in the top third of the range (and preferably in the top quarter).
- In a down bar, the open forms at least in the top third of the range (and preferably in the top quarter), and the close is in the bottom third of the range (and preferably in the bottom quarter). Figure 1.21 illustrates the bars where the open and close are at one-third of the range and one-quarter of the range.
- It has at least 50% of its range above the breakout point.
- It would also be nice (but not necessary) that the range and volume of the breakout day is twice that of the previous day.
- The breakout bar should not be the result of news—for instance, monthly economic reports (retail sales, unemployment, etc.). This distinction

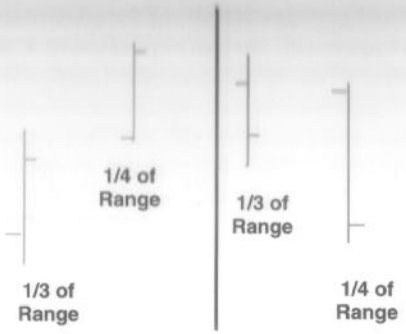


FIGURE 1.21 Wide-Range Breakout Bar

between a wide-range breakout bar that is news-driven, and one that is not, is important. A news-driven breakout bar is a less robust breakout signal. It generally will fail to hold the Primary Zone. For example, an upside breakout will retrace below the Primary Sell Zone. A breakout that is not news-driven will normally retrace to the Primary Zone but will not breach it.

Figure 1.22 shows the normal move in a breakout situation.

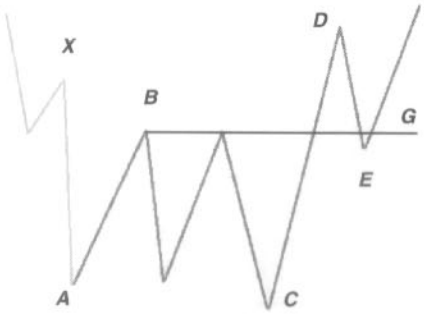


FIGURE 1.22 Wide-Range Breakout Bar, Non-news-driven

The R1 is the easiest to trade. The retracements are within most traders' expectations, allowing responsive traders to get on-board, and the breakout traders are not subjected to undue stress and pain by the retracement's magnitude. The R2 is another matter altogether.

Above-Normal Moves (R2)

Usually, in an R2 we won't see any retracement in its own swing size; we'll see retracements only in the first or second lower time frame. The stronger the move, the more likely it is we will see retracements in the second lower time frame. Figure 1.23 shows a real-time R2 example.

FIGURE 1.23 S&P, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

From July 18, 2006 to February 22, 2007, the S&P appreciated 19.35%. This is just above normal for a 5-day swing. Notice that the only swings that occurred were 5-day swings.

SUMMARY

In this chapter we have covered three topics:

1. We looked first at my belief structure about trading success and the markets. The key points made were:
   - Success is a combination of winning psychology, effective money management, and a written trading plan. A mechanical trader needs a vastly different plan than that used by a discretionary trader.
   - The markets are fractal and complex (within the meaning of Complexity Theory) by nature. For this reason, technical analysis can give a trader/investor an edge.
2. We then took an in-depth look at the structure and nature of trends.
3. We then looked at how the Barros Swing helps us identify the nature of the trend of a specific time frame. Once you have identified the nature of the trend, you have your strategy. You are now able to identify and

label horizontal trends, uptrends, and downtrends. For the directional trends, you are able to say whether the uptrend or downtrend is below normal, normal, or above normal. You are also able to speculate on the consequences of making these distinctions. You also know how congestion markets form, and how to label them, and you have a strategy for trading them.

Once you have identified the current trend, the next step is to be able to say when that trend changed. That's the subject of the next chapter.

CHAPTER 2

Change in Trend Patterns

INTRODUCTION

In Chapter 1 we examined ways of identifying the trend of a time frame. I started with trend identification because, by identifying the trend, we place the probabilities of success in our favor. For this reason, recognizing the trend forms the most important part of my analysis. If I get that right, then a successful trade will usually follow. In relation to trends, Pete Steidlmayer used to ask:

1. *What's the direction?* And
2. *Will it continue or change?*

We examined the direction of trends—up, down, and sideways (or horizontal)—in Chapter 1. More importantly, in that chapter we noted the important principle that **trends are linked to a time frame**. So, the first question above should be rephrased as: *What's the trend of the . . . [time frame]?*

For example, *What's the **monthly** trend?*

In this chapter, we will attempt to find ways to answer the second question: *Will it continue or change?*

The pictorial road map depicted in Figure 2.1 shows the main trend patterns discussed in this chapter.

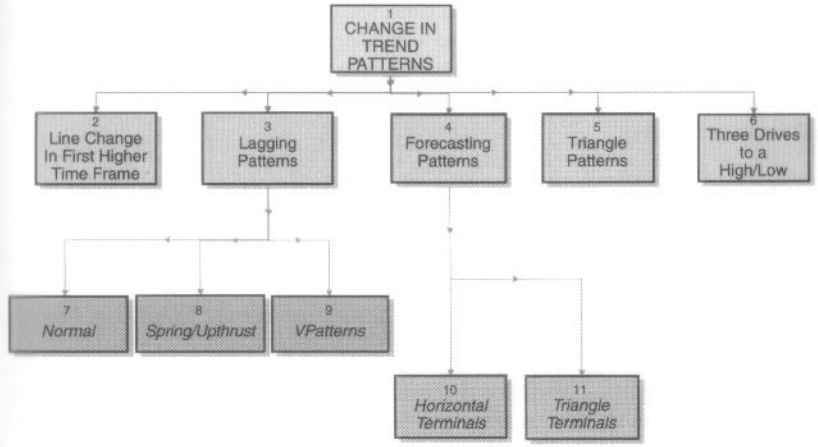


FIGURE 2.1 A Pictorial Road Map of Chapter 2

Let's first review the process for a change in trend. To change from an uptrend to a downtrend, we must first have acceptance of prices below a prior swing low and then have a series of lower lows and lower highs. A breach of the prior low will end the time frame's uptrend, but *a downtrend doesn't commence until we get a series of lower lows and lower highs.* Figure 2.2 illustrates the change in trend road map from up to down. The reverse is true for a change in trend from down to up.

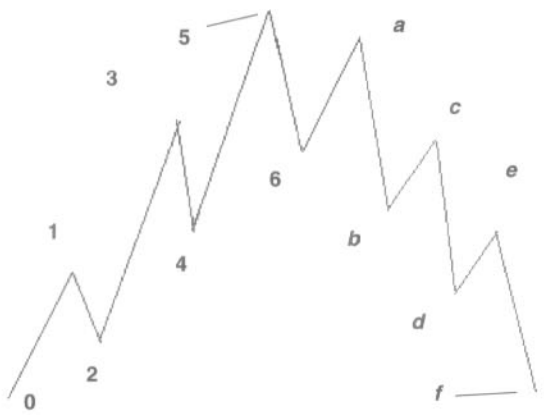


FIGURE 2.2 Uptrend and Downtrend Sequence

In Figure 2.2, the waves labeled with numbers (except 6) form part of the uptrend; those labeled with letters (and 6) form part of the downtrend. We don't have a confirmed change in trend (from up to down) until *d*, when we form a series of lower lows and lower highs (*a* to *d*).

Does this mean that we have to wait for a staircase pattern before we change our strategy? If I were a trend follower, then the answer would be an unequivocal "Yes!" But I don't believe we have to wait for the staircase structure in order to trade the change in trend. I say this because we have at our disposal certain high-probability patterns that enable us to anticipate a change. I have classified the patterns as follows:

- *Change in the first higher time-frame line direction:* This will occur every time there is a change in trend.
- *Lagging patterns:* One of these will be present in 92% of changes in trend.
- *Forecasting patterns:* These take place in the first lower time frame but forecast a change in trend in the trader's time frame. *What does this mean,* you ask? Let's look at an example.

  If we are trading the 18-day (monthly) trend, the pattern will appear in the first lower time frame, the 5-day (weekly). But here is the critical point: *Although it takes place in the 5-day time frame, it has implications for the 18-day trend!*

- *The triangle change in trend patterns:* Ultimately, these form a Normal change in trend pattern. However, they have certain characteristics that make a separate category worthwhile.
- *The three drives to high/low patterns:* This unique pattern ultimately forms one of the lagging patterns.

We will now look at each of these patterns in turn.

CHANGE IN THE FIRST HIGHER TIME-FRAME LINE DIRECTION

The simplest rule for a change in trend is: *A change in the line direction in the swing of the first higher time frame means the trend of the trader's time frame has changed, **whether or not a change in trend pattern is present and whether or not the trader's time frame forms a Whole Point Count.***

The Whole Point Count (WPC) is one of two time filters I use to guard against false breakouts. The other is the Line Change Count (LCC). Later in this chapter, we'll become better acquainted with both of these filters. For the moment, just be aware that the WPC and LCC increase the probability that a change in trend is occurring.

Figure 2.3 shows the Line Direction Change rule in operation in the 13-week swings in the S&P (cash). The 13-week line will turn down if the market trades at 956.27. And if the market trades at that price, the *18-day swing* will be deemed to change its trend whether or not one of the change in trend patterns is present.

FIGURE 2.3 S&P, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

LAGGING PATTERNS

Key Ideas

Before we look at the patterns themselves, we will consider some key ideas.

For there to be a change in trend, there must first be a sustained uptrend or downtrend

In other words, before we have a change in trend from up to down, we must first have a series of higher highs and higher lows. The greater the number of higher highs and higher lows, and the longer the time span the uptrend encompasses, the greater the probability that the change in trend pattern will prove valid. The same holds true for downtrends.

If an opposing change in trend pattern follows a WPC, it is probable that the market is forming a sideways market either in the trader's time frame or in the first higher time frame

The same can be said where the initial change in trend fails to form a WPC. This usually occurs where the change in trend is deemed to occur because the first higher time frame has changed its line direction. Let's see this idea in action in real time.

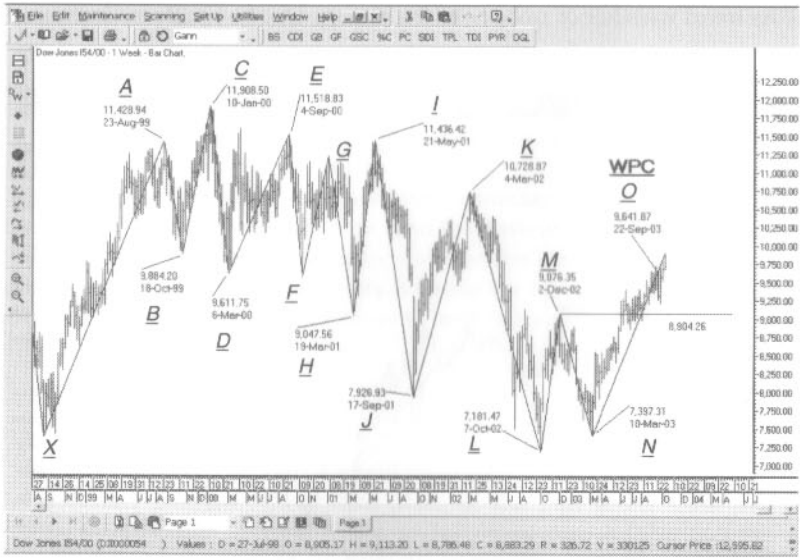


FIGURE 2.4 Dow Jones, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

Figure 2.4 is the 13-week price action of the Dow Jones Industrial Average (DJIA) following its all-time high of 11,908 on January 10, 2000. The price action from October 18, 1999 shows the following:

- On January 10, 2000, the market breaches the high at *A*, 11,429, at *C*; from *C* the market returns to the *A*/*B* congestion range. The boundaries are now the high at *C* and the low at *B*.
- On March 6, 2000, the market then breaks the low at *B* at *D*, so that the boundaries of congestion are now *C*/*D*.
- The next important event is at *H*. *E* is below *C*, so *C* remains the high; and as *F*/*G* is an inside swing, it can be ignored.
- On March 19, 2001, the market takes out *D* at *H* and returns to congestion. A reaction high forms at *I*. The high of the sideways market remains at *C*, as *I* is below *C*. Hence, the boundaries of congestion are now *C*/*H*.
- There has been no WPC between *C* and *I*, and hence no confirmed change in trend.
- On September 17, 2001, the 12-month line turns down at *J*. Accordingly, the 13-week trend is deemed to be down. But note that no WPC has formed at *J*. In fact, no WPC forms in this downtrend.
- On September 22, 2003, the market changes its trend from down to up and a WPC does form, confirming the new 13-week uptrend. This price action suggests that the 12-month is forming a sideways trend. The upper boundary is *A* at 11,908 (plus any maximum extension), and the lower boundary is *B* at 7,181.

You will find it easier to apply the patterns if you focus on correct labeling

The four labels we use to identify the critical swing points are: *X*, *A*, *B*, *C*. In an uptrend, *X* and *B* are always lows, and *A* and *C* are always highs. In a downtrend, *X* and *B* are always highs, and *A* and *C* are always lows. *X*/*A* should be at least impulse mean. In this context, I define "impulse" as a move in the direction of the trend, and the "mean" as the "average." In the calculation of "mean impulse moves," I make no distinction between up and down moves.

Figure 2.5 identifies, for both uptrends and downtrends, the impulse swings we use to calculate the impulse mean.

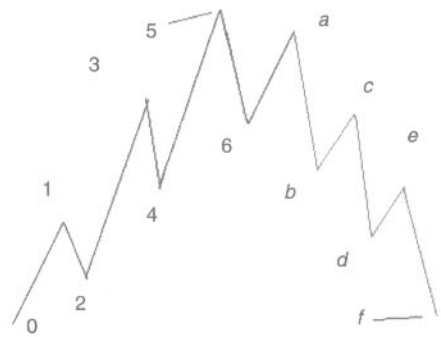


FIGURE 2.5 Impulse Waves

We include waves 1, 3, 5, 6, *b*, and *d* when calculating the "mean impulse." We don't include *f*, as it's not complete; it won't be complete until the line turns up. Figure 2.6 illustrates the correct labeling for the market when it was at 3.

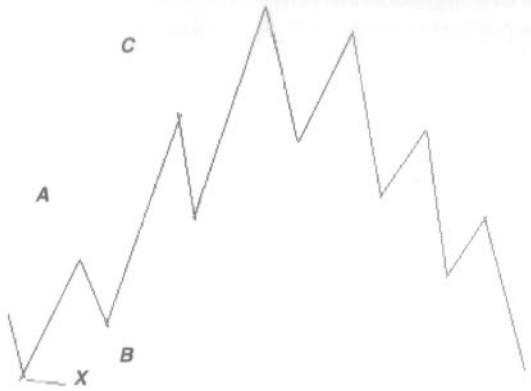


FIGURE 2.6 Impulse Wave Labeling

Figure 2.7 shows the re-labeling after the market moves above *C* (in Figure 2.6) by a margin greater than the maximum extension.

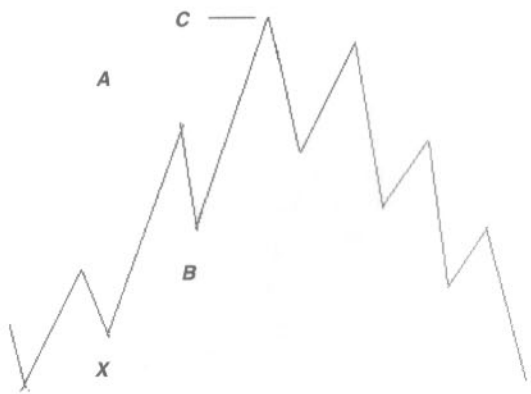


FIGURE 2.7 Impulse Wave Labels

Recall from Chapter 1 the meaning of maximum extension: As soon as the market accepts beyond *A* by 20% of *A*/*B*, or by greater than 10% of *X*/*A*, whichever is the greater, we assume the uptrend will continue. This assumption is invalidated if the low at *B* is breached.

Recall also from Chapter 1 that, for optimum results, I recommended you should use both figures. However, I commented there that many people don't calculate the impulse mean—a calculation that is needed for *X*/*A*. So, if you wish, you can use 20% of *A*/*B* on its own, as it produces acceptable results.

Once the market accepts above *A*/*B* by its maximum extension, *B* becomes *X* and *C* becomes *A*, *as long as the previous low remains intact—that is, there is no breach of the prior low*. We continue in this manner until the market breaches *B*. Once the market accepts prices beyond *B* by an amount greater than the maximum extension, and a WPC forms below *B*, we assume a downtrend is in place. Also, we adopt the labeling appropriate to a downtrend—that is, *X* is always a high, *A* a low, *B* a high, and so on.

Always bear in mind that in a downtrend, *X* and *B* are always highs and *A* and *C* are always lows. *X*/*A* should be at least impulse mean. It's worth repeating that "impulse" is defined as moves in the direction of the trend, and that "mean" means "average."

Note that in an uptrend, we label *X* only after the line turns and heads toward *A*; similarly, we label *A* only after the line turns, and so on.

In a sideways market, *A*/*B* usually marks the boundaries of congestion. Any waves within *A*/*B* are "inside waves" and are ignored in change in trend patterns. Let's look at the example in Figure 2.8.

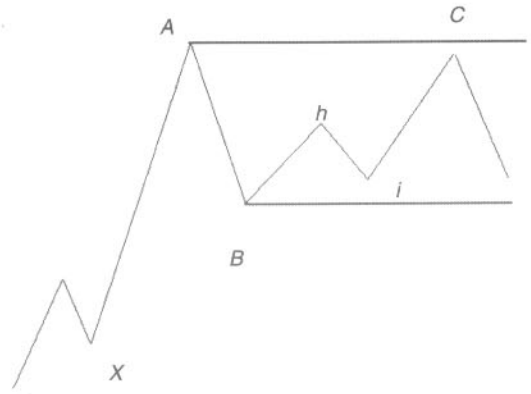


FIGURE 2.8 Inside Waves in a Change in Trend Pattern

In Figure 2.8, all price action after *B* is within the boundaries of *A*/*B* and is disregarded when identifying change in trend patterns. When the market extends the range of the sideways market and returns to congestion, *A*/*B* needs to be re-labeled. Figure 2.9 illustrates a number of ways this occurs. (This is by way of review only, as we covered this subject in depth in Chapter 1.)

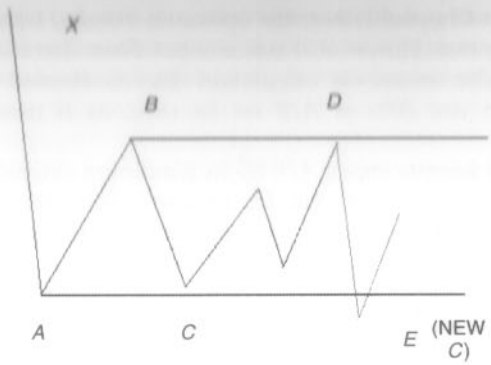


FIGURE 2.9 Re-labeling *A/B*: I

Figure 2.10 shows another re-labeling situation.

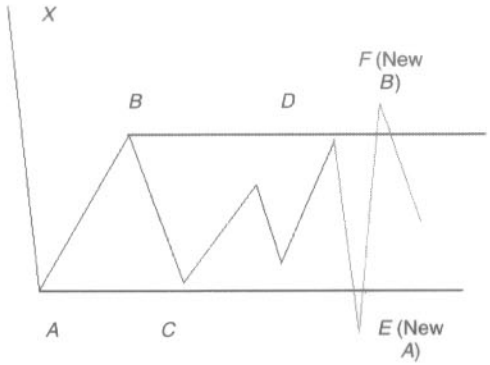


FIGURE 2.10 Re-labeling *A/B*: II

Time and price filters are used to identify false breakouts

I use time and price filters to achieve maximum extension while guarding against false breakouts. The time filters are the Whole Point Count and the Line Change Count, which are derived from Joseph Hart's newsletter titled *Trend Dynamics*. (*A caveat:* The ideas presented here represent my interpretation and adaptation of Hart's concepts and should not be taken as an accurate reflection of his ideas. I have also changed their titles in a minor way to distinguish them from Hart's formulation.)

The Whole Point Count

In a new downtrend, a WPC is defined as the number of consecutive highs that must remain at or below *B* when changing the trend from up to down; when changing the trend from down to up, it is the number of lows that must remain

at or above *B*. We can put this another way: in a downtrend, a WPC is defined by the number of whole bars at or below *B* when changing the trend from up to down; when changing the trend from down to up, it is the number of whole bars that must remain at or above *B*. The number of consecutive days is half the swing magnitude of the time frame under consideration. For example:

> *For an 18-day pattern to change from up to down, the WPC is defined as* ***9 consecutive days*** *where the high is at or lower than the breakout point* B.
>
> *For an 18-day change pattern to change from down to up, a WPC is defined as* ***9 consecutive days*** *where the low is at or higher than the breakout point* B.

Another way of saying this is: for a WPC to form, there must be whole bars at or beyond the breakout point for consecutive days amounting to half the swing size.

The days must be consecutive. Let me illustrate the ramifications of this principle with an example. In a new uptrend, there are lows above *B* for four consecutive days. But, on the fifth day, its low dips below *B*. Because of the "consecutive principle," the count starts again.

If that's the WPC, what is an LCC?

The Line Change Count

The LCC is a method for identifying whether there is enough directional momentum to confirm a new trend. Hart's research showed that a rating of +3 would confirm the new breakout. Again, the best way of describing the idea is by way of an example.

Figure 2.11 shows the formation of a new uptrend.

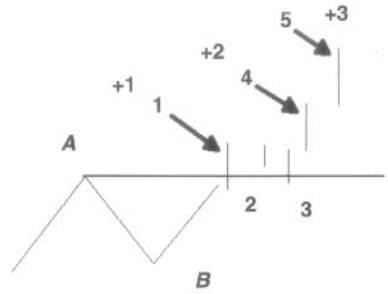


FIGURE 2.11 LCC Showing +3 Momentum

On day 1, the market breaks above the breakout point at *A*. We give the market a rating of +1. The important boundaries are now the high and low of day 1. If the boundary is breached in the direction of the new trend, we give the new high

a rating of +1 and add it to the cumulative total. Hence on day 4, we get a rating of +2: the +1 on day 1 added to the +1 of day 2.

A breach against the new trend receives a rating of −1. In this case, if day 1's low is breached, we assign it a rating of −1 and take it from the cumulative total. Once the cumulative total reaches 0, the count is reset; that is, we never give the structure a minus rating.

An inside bar receives a rating of 0. To identify an inside bar, we use the extremes of the directional move as boundaries. For example, in Figure 2.11, days 2 and 3 are inside bars relative to day 1, because day 1's boundaries form the extremes of the directional upside breakout. On day 4, the high of day 1 is breached. To identify an inside bar, the boundaries used are now the high of day 4 and the low of day 1.

Note: The breach of the maximum extension, the presence of a WPC, and a +3 LCC means we change our strategy; it doesn't mean we immediately initiate a new trade. To take a trade, we need to meet not only the requirements for trend identification but also those for low-risk entry—that is, zones, setups, triggers, initial stops, and the appropriate risk/reward—all the subjects of later chapters.

In descending order of importance, the three change of trend filters rank as follows:

- Whole Point Count. The absence of the WPC negates the probability of a change in trend, unless we have a series of lower lows and lower highs in a change in trend from up to down (and the reverse for a change in trend from down to up).
- Line Change Count.
- Maximum extension.

You need to remember the key ideas discussed in this section. Indeed, they are so important, I would suggest that you don't proceed until you are confident you have a good working knowledge of these concepts.

Characteristics of Lagging Change in Trend Patterns

There are three lagging patterns. In order of their frequency of occurrence, they are the:

- Normal pattern;
- Spring (for a change from bear trend to bull) and Upthrust (for a change from bull to bear) patterns; and
- Vtop (for a change from bear trend to bull) and Vbottom (for a change from bull to bear) patterns.

Normal pattern

About 60% of changes in trend exhibit this pattern. Figure 2.12 shows a Normal trend change from up to down.

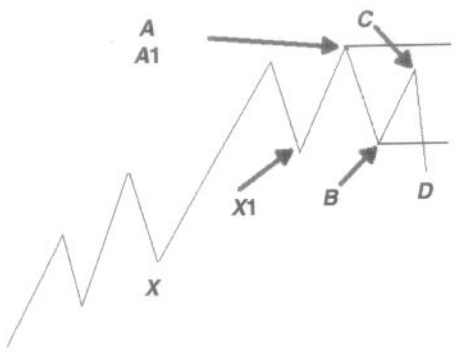


FIGURE 2.12 Normal Change in Trend Pattern: from Bull to Bear Trend

Characteristics of the Normal pattern

C is below *A*. After the lower high at *C*, the market can do one of three things:

- The market forms a congestion zone and somewhere above *B* turns up. We call this point *D*. This leads to a trading range bounded by *A* and *B*.
- *D* forms below *B* without beginning a new downtrend. Instead, it returns to congestion so that the new boundaries are *A*/*D*.
- *D* forms below *B* with the requisite WPC. In the process, there will be the LCC, and the market will accept prices below *B* by greater than the maximum extension. The market then goes on to form a series of lower lows and lower highs, leading to a downtrend.

Once the WPC forms and the market accepts prices below *B*, we *assume* the trend has changed and we change our strategy from initiating longs to initiating shorts. The price filters (the LCC and maximum extension) will provide an early warning of a change in trend and/or qualify the quality of the WPC. Figure 2.12 provides an example of a Normal change in trend from a bull to a bear trend.

In Figure 2.12, there would be a world of difference between a WPC that forms without an LCC and maximum extension, and one that forms with both. The latter shows strong momentum in the direction of the possible downtrend; whereas the former is more likely than the latter to be a false breakout. That is, instead of forming a downtrend, the market returns to congestion.

Figure 2.13 shows the Normal pattern when the trend changes from bear to bull.

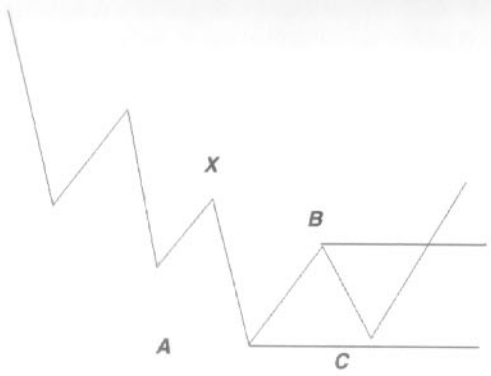


FIGURE 2.13 Normal Change in Trend Pattern: From Bear to Bull Trend

Other important elements in a change in trend pattern are the Primary Buy Zones (PBZ) in a bull to bear trend, and the Primary Sell Zones (PSZ) in a bear to bull trend. In the bull to bear trend, the upper boundary of the PBZ should hold any test of the breakout. The PBZ is the zone encompassing the low and the zone that is calculated by the following formula:

Higher boundary (PBZ): *Low* + (A − B)/8.

So, the PBZ is bounded by the "low of B" *and the "low of* B + (A − B)/8."

A retracement following a downside breakout should find resistance between the low and the higher boundary.

In the bear to bull trend, the lower boundary of the PSZ should hold any test of the upside breakout. The PSZ is the zone encompassing the high and the zone that is calculated by the formula:

Lower boundary (PSZ): *High* − (A − B)/8.

So, the PBZ is bounded by the "high of B" *and the "high of* B − (A − B)/8."

A breakout retracement should find support between the price high (or low) and the lower boundary (higher boundary) of the zone.

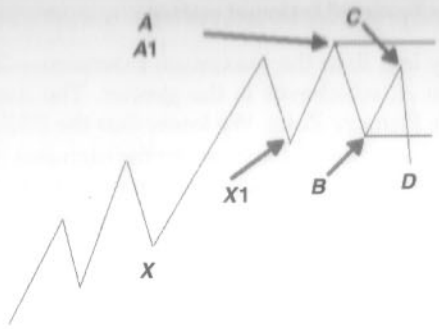


FIGURE 2.14 Normal Change in Trend Pattern: From Bull to Bear Trend

As an important aside, let's have another look at Figure 2.12 (reproduced here as Figure 2.14). Notice the position of *X*1 and *X*. Let's assume:

- You have taken the trouble to calculate the impulse mean.
- You find that *X*1/*A*1 is not impulse mean. So, you move your base of calculations from *X*1 to *X*, where you find that *X*/*A*1 is at least impulse mean. *A*1 now becomes *A*, so that the maximum extension from *XA* is calculated from *X*/*A*1. Don't be confused by the re-labeling; *A* and *A*1 label the same high. I changed the high's nomenclature to relate *A* to its *X* counterpart.
- For example: *A*1 is 1000 and *X*1/*A*1 is 100 points. If 100 points were impulse mean, then the maximum extension would be (100 + 1000 =) 1100. However, we have said 100 points is not impulse mean. So, we move the calculation to *X*/*A*1 and find it is 600—which is at least impulse mean. We add 60 to *A*1 and identify the maximum extension level as being (1000 + 60 =) 1060. We now label *X*/*A*1 to *X*/*A*.

This distinction is important when we consider the next pattern, the Spring/Upthrust.

Spring/Upthrust pattern

We find this pattern in about 25% of the changes in trend. It is the most reliable of the three patterns; in fact, it is so reliable, we assume that, at the very least, the market will head toward *B* after returning through *A*. More importantly, we assume not only that it will return to *B*, but also that the market will change its trend.

Although Richard Wyckoff used different names to identify the change from bull to bear (an Upthrust) and the change from bear to bull (a Spring), the essential characteristics of both are the same.

Characteristics of the Spring/Upthrust pattern

C moves beyond *A* by less than the maximum extension—20% of *A*/*B* from *A*, and 10% of *X*/*A* from *A*, whichever is the greater. The market then re-enters congestion beyond the Primary Zone. We know that the PBZ is between the low and "low + (*A* – *B*)/8," and the PSZ is between the high and "high – (*A* – *B*)/8." In other words, in an Upthrust, the pattern is complete when the market accepts below the price "high – (*A* – *B*)/8"; in a Spring, the pattern is complete when the market accepts above the price "low + (*A* – *B*)/8."

Let's look at the Upthrust in Figure 2.15.

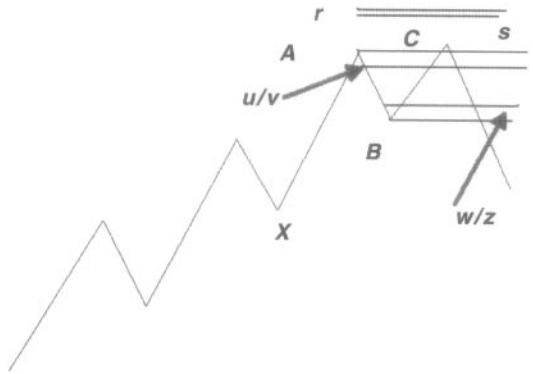


FIGURE 2.15 Upthrust Pattern

In Figure 2.15, *C* breaches *A* by less than the maximum extension level; *r*/*s* (lines marked *r* and *s*) represents the maximum extension. Given the change in trend assumptions I make when this pattern occurs, I insist that *C* MUST fail to accept beyond the maximum extension for the price action to qualify as an Upthrust or Spring. In short: *Reach maximum extension is OK; acceptance beyond is not.*

The market then re-enters congestion and accepts below the lower boundary of the Primary Sell Zone. In Figure 2.15, *u*/*v* represents the lower boundary of the Primary Sell Zone—that is, *A* – (*A* – *B*)/8.

Once the market accepts below the lower boundary of the Primary Sell Zone, we can expect it at least to head to the Primary Buy Zone. In Figure 2.15, *w*/*z* represents the upper boundary of the Primary Buy Zone. However, once the market accepts below the Primary Sell Zone, it is more than likely that it will now change its trend and accept prices below *B*.

Figure 2.16 shows a Spring—the reverse of the Upthrust.

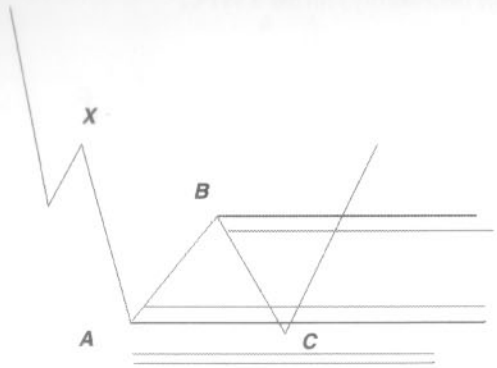


FIGURE 2.16 Spring Pattern

The important zones in this pattern are the Primary Buy Zones in a bull to bear change and the Primary Sell Zones in a bear to bull change.

In the bull trend to bear, to complete the pattern, the market needs to accept beyond the lower boundary of the PSZ—that is, the zone calculated by the formula:

$$High - (A - B)/8$$

In the bear trend to bull, to complete the pattern, the market needs to accept beyond the upper boundary of the PSZ—that is, the zone calculated by the formula:

$$Low + (A - B)/8$$

The Spring/Upthrust completes the second of the three lagging change in trend patterns. The last is the "V" formation.

Vtop and Vbottom patterns

These patterns are rare in liquid markets. Together, the two events—the "V" formation and the line change in the first higher time frame—only have a 15% chance of occurring.

Characteristics of the Vtop and Vbottom patterns

The "V" formation usually results in sideways trends that last an exceptionally long time. They are an exception to the rule that we assume a trend will continue if the market accepts beyond the maximum extension. In the "V" patterns, the maximum extension is exceeded greatly and then—surprise!—*B* is breached!

"V" formations have a unique sequence of events. We see that sequence in Figures 2.17 to 2.19. In Figure 2.17, after the high at *C*, the market breaches *B* and then usually (but not necessarily) forms a WPC.

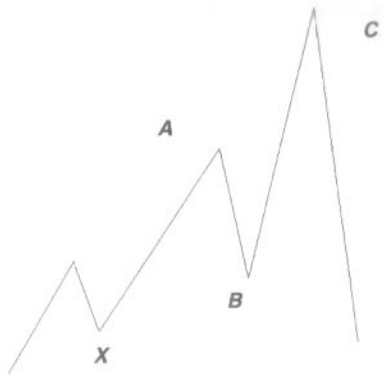


FIGURE 2.17 Vtop Pattern: Breach of B

As Figure 2.18 shows, *if there is to be a change in trend*, the market moves up to either 50% of *A*/*B* or to the Primary Sell Zone at *A*. At this point, *C* becomes *A*, the new low becomes *B*, and—when the market turns down after finding resistance at either 50% of *A*/*B* (old) or at *A*/*B*'s (old) Primary Sell Zone—that new reaction high is re-labeled *C*. (The *C* is *not* shown in Figure 2.18 but is shown in Figure 2.19.)

In Figure 2.18 we see the uptrend failing at the old *A*'s Primary Sell Zone. (The "old *A*" in Figure 2.18 is re-labeled from Figure 2.17's *A*.)

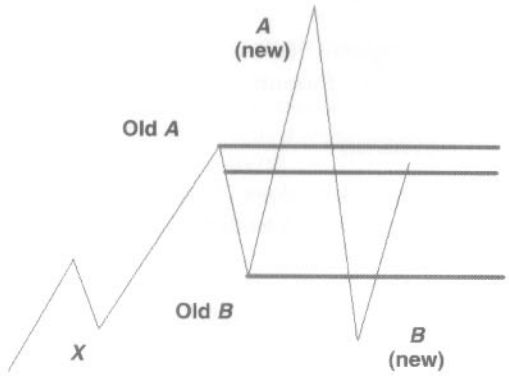


FIGURE 2.18 Vtop Pattern: Re-entry into Previous Corrective Range

Finally, in Figure 2.19, we see a new downtrend commencing.

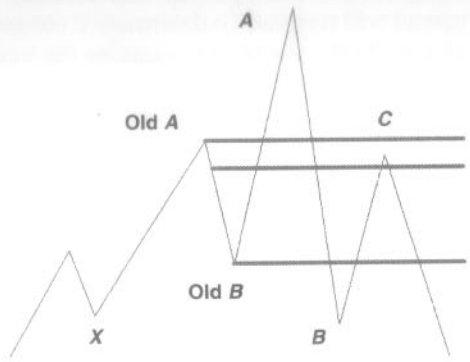


FIGURE 2.19 Vtop Pattern: Start of New Downtrend

There are some rare occasions when the sequence of events described above doesn't take place. Instead, the market doesn't pause beyond *B* and merely proceeds to accept prices beyond *X*. When that occurs, the "V" formation is deemed a "Normal" change in trend pattern. This means that once the market accepts prices beyond *X*, we assume a change in trend has occurred and we alter our trading strategy to accommodate the new trend.

A Vbottom is the mirror-image of a Vtop. Figure 2.20 shows the pattern.

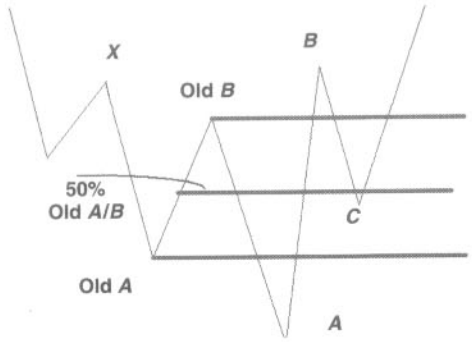


FIGURE 2.20 Vbottom Pattern

I will now turn to the signs that a Vtop or Vbottom won't lead to a change in trend.

What signs tell us that a Vtop/Vbottom won't result in a change in trend? The key sequence takes place after the new *B* forms. We know that a new *C* will form either at the 50% level of the old *A*/*B* or at the old *A*/*B* Primary Zone. Once the

market exceeds the old Primary Zone, it will form a congestion zone between the new A and new B, or the original trend will resume.

In the context of Figure 2.19, the uptrend will resume; in the context of Figure 2.20, the downtrend will resume. To determine if congestion or a resumption of the old trend is more likely, we need to examine the trend and its position in the first and second higher time frame.

The important zones in this pattern are the Primary Zones of the old A/B and the 50% zone of the old A/B range.

Summary of Lagging Change in Trend Patterns

1. The three patterns appear in 92% of changes in trend. The remaining 8% of changes in trend are discerned by a line change in the first higher time frame. In other words, 8% of the time, the change in trend is NOT flagged by any pattern.
2. Each pattern has its own unique characteristics that the trader MUST learn and integrate. These characteristics include the way the patterns form, and the patterns' zones.
3. In Spring or Upthrust patterns, we assume a change in trend when the market returns through A and accepts past the boundary of the Primary Zone.
4. In Vtops or Vbottoms, we assume a change in trend if the market holds either the 50% retracement of the old A/B or the Primary Zone of the old A/B.
5. In Normal patterns, we don't assume a change in trend until we have acceptance of prices beyond B and we have (in order of importance):
   - the formation of a WPC; and
   - the formation of a "+3 LCC"; and/or
   - the market accepting prices beyond the maximum extension.

The remaining sections in this chapter cover "special" change in trend patterns. Usually, these special patterns ultimately form a Normal pattern. However, by identifying the special patterns, we can anticipate a change in trend BEFORE the market accepts prices beyond B. The first of these special patterns are the forecasting patterns.

FORECASTING PATTERNS

Forecasting patterns occur in the first lower time frame but warn us of a change in trend in the trader's time frame. They are a warning beacon to the trader/investor that their strategy has to alter. Figure 2.21 illustrates the idea, using a forecasting pattern called the Diagonal Terminal Triangle.
In Figure 2.21:

- The 18-day swings are labeled X, A, B, C.
- The 5-day swings are labeled X, a, b, c, d, e.
- I have drawn trend lines across the highs and lows of the Diagonal Terminal.

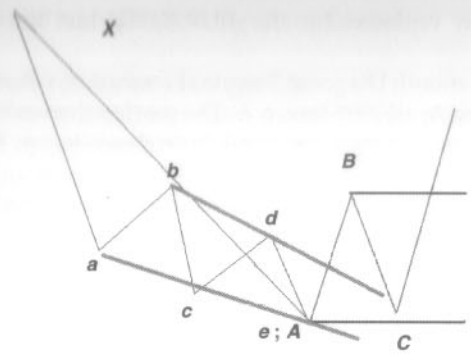


FIGURE 2.21 Diagonal Terminal Triangle

- I have drawn horizontal lines at A and B to mark the boundaries of the 18-day congestion.

Note that, in this example, the end of the forecasting pattern at e is the same as the end of the 18-day downtrend (A). Rather than wait to go short at B, the Diagonal Terminal warns us that the high-probability trades are now on the long side, rather than the short.

Figure 2.21 shows a "deep C." This is not a necessary characteristic of a Diagonal Terminal.

Let's examine the real-time example in Figure 2.22. The figure shows the 12-month and 30-month swing in the USD/DEM. In terms of liquidity, the

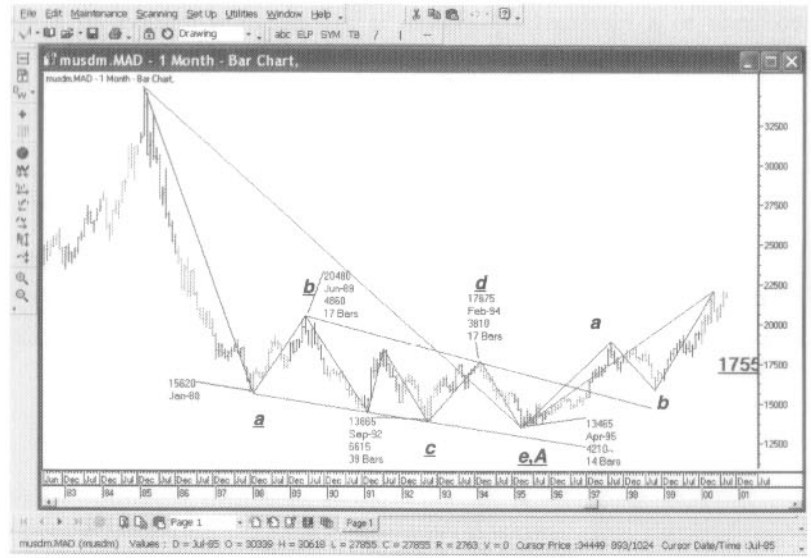


FIGURE 2.22 USD/DEM 12-Month Diagonal Terminal Triangle
Source: Graphics used with permission from *Market Analyst*.

instrument has been replaced by the EUR/USD, but the chart is instructive.

Notice that the 12-month Diagonal Terminal warned of a change in trend in the 30-month swing at the April 1995 low, *e*, *A*. The market then exhibited a 12-month Normal change in trend, altering the trend from down to up. The 30-month line change also changed the 12-month trend.

The 12-month retracement from the second *a*/*b* was a shallow one. But for the Diagonal Terminal, we would probably have interpreted the move from the second *a* as the start of a 12-month congestion zone or the resumption of the 30-month downtrend. The Diagonal Terminal allowed us to anticipate a change in trend and to position ourselves for the rally from the second *b*.

Forecasting patterns don't occur often; nevertheless, learning to see them form will be financially beneficial.

There are two main categories of forecasting patterns:

- horizontals; and
- triangles.

Horizontal Patterns

The two horizontal patterns are the Horizontal Terminal and the Horizontal Complex Terminal. Let's look first at the Horizontal Terminal.

Horizontal Terminal

The precursor to a Horizontal Terminal is a congestion market. In a sense, Horizontal Terminals are complex congestion markets. This means that in a Horizontal Terminal, we have boundaries of congestion. Unless we can draw the horizontal trend lines, we don't have a horizontal pattern. Figure 2.23 is an example of a Horizontal Terminal.

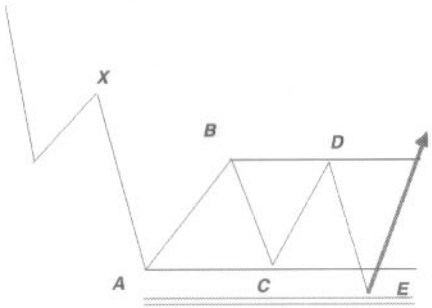


FIGURE 2.23 Horizontal Terminal

A Horizontal Terminal has the following characteristics:

- *A*/*B* mark the boundaries of congestion.
- The lines below *A* and *C* represent the maximum extension limits.
- *C* retraces *A*/*B* between 100% and 90% of *A*/*B*. *E* moves below *A* **and** *C*, but *E* remains above the maximum extension.
- There is no WPC at *E*.
- Generally, *D* is below *B*. Where *D* is above *B*, it will usually not be by more than the maximum extension limits. *D* must also be at least 78.6% of *B*/*C*.

The essential points to notice are:

1. *B* and *D*, and *A* and *C* are almost at the same price level.
2. *C* retraces *A*/*B* between 100% and 90% of *A*/*B*.
3. *E* moves below *A* **and** *C*.

Let's consider another real-time example in Figure 2.24.

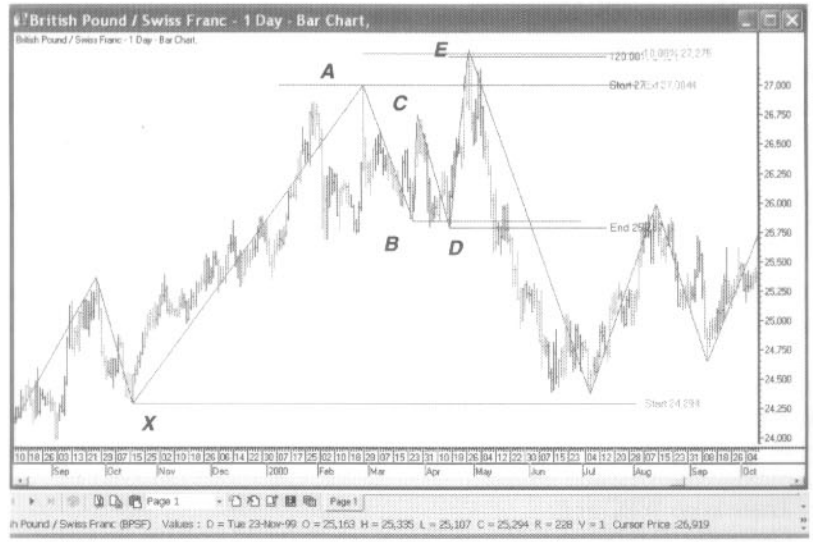


FIGURE 2.24 GBP/CHF, Cash, Daily Horizontal Terminal
Source: Graphics used with permission from *Market Analyst*.

We are examining the 18-day swing of the GBP/CHF. Notice that this real-time example deviates from the ideal in a number if ways:

- *C* is just within the 78.60% requirement.
- *D* is marginally below *B*.

- E is marginally above the maximum extension limits without accepting above them.
- The boundaries of congestion are marked by A/D and not A/B, as is usually the case.

The example illustrates the principle that history never repeats itself exactly. So, don't expect patterns to follow the ideal; indeed, they usually deviate. In any pattern, identify and look for the core elements. In the case of a Horizontal Terminal, the core elements are:

- a congestion market where C makes a deep retracement of A/B; E is beyond both A and C; and
- the failed attempt by the market to break out of congestion.

All other distinguishing features are tools to help us identify the pattern as it forms.

Let's now turn to the Complex Horizontal Terminal.

Complex Horizontal Terminal

The Complex Horizontal Terminal is a variation of the Horizontal Terminal. The difference between the two lies in the retracement of A/B by C. In the Complex Horizontal, it retraces A/B by less than 90%. (However, it must retrace A/B by at least 78.6%.) Because of this shallower retracement, E may either:

- move beyond A, **but** above C; **or**
- move beyond A **and** C.

In all other respects, E shares the same core elements of the Horizontal Terminal. Therefore, its distinguishing features are as follows:

- C retraces A/B by less than 90% and at least 78.6% of A/B.
- E moves *either* beyond A but *not* C, *or* beyond both A and C.
- In any event, E is beyond the extreme of the pattern by less than the maximum extension limits.
- There is no WPC at E.
- Generally, D is below B. Where D is above B, it will usually not be by more than 20% of A/B. D is also at least 78.6% of B/C.

We have an idealized picture in Figure 2.25 of a Horizontal Complex Terminal warning of a change in trend from down to up.

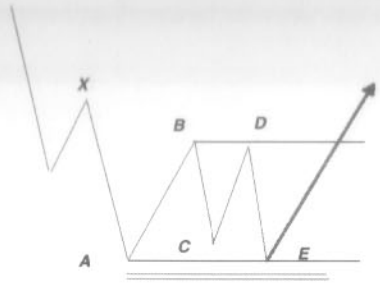


FIGURE 2.25 Complex Horizontal Terminal

We have now completed the horizontal patterns. Let's turn to the Triangle Terminals.

Triangle Terminals

There two types of Triangle Terminal: the Diagonal Terminal and the Expanding Terminal.

Diagonal Terminal

A Diagonal Terminal has the following characteristics:

- It should not be confused with a triangle change in trend pattern. In the Diagonal Terminal, in a downtrend the apex is sloping down, while in an uptrend it is sloping up.
- There is time symmetry between A/B and C/D. Time symmetry occurs when the swings A/B and C/D are within a 20% time span. For example, if A/B takes 10 trading days, C/D *must* be between 8 and 10 days. There may be intervening swings between A/B and C/D, but the swings won't be symmetrical in time.
- The trend lines, across the highs and lows of the pattern, converge.
- Once E forms, a rapid move occurs against the prevailing trend.

Figure 2.26 is an idealized version of the pattern; Figure 2.27 is a real-time example in the 12-month and 30-month swing of the USD/DEM. We considered the Diagonal Terminal and USD/DEM chart earlier.

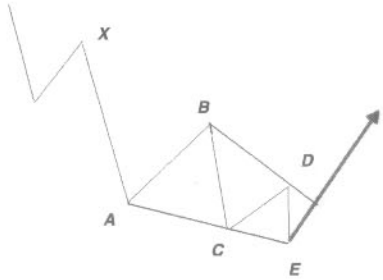


FIGURE 2.26 Diagonal Terminal

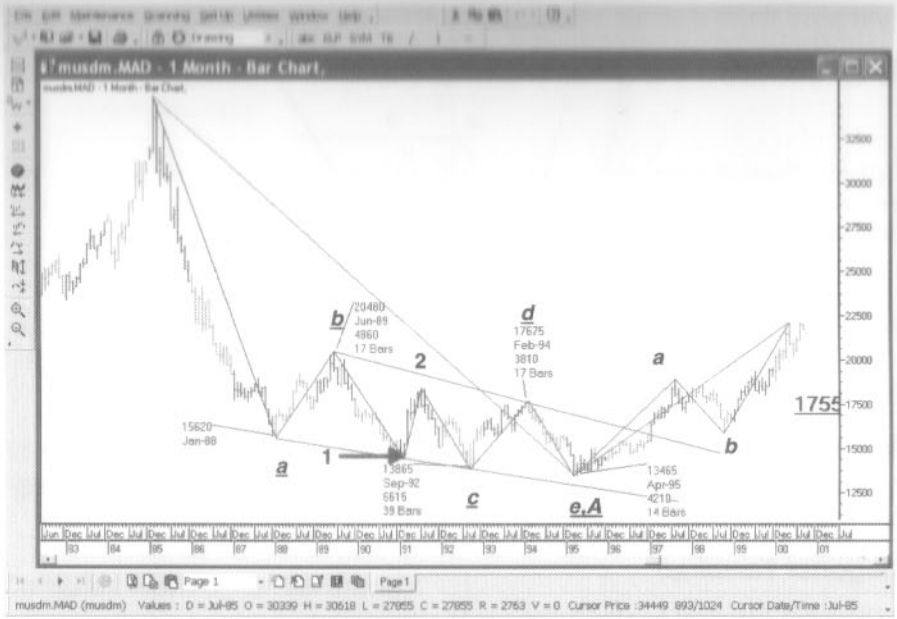


FIGURE 2.27 USD/DEM, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

Notice that in Figure 2.27, the swing 1/2 doesn't form time symmetry with *a*/*b*; notice also that *c*/*d does* form time symmetry. Non-symmetrical swings between *a*/*b* and *c*/*d* don't invalidate the pattern.

If we don't have time symmetry between *a*/*b* and *c*/*d*, we don't have a Diagonal Terminal. On the other hand, we may have Three Drives to a Top/Bottom, but I'll tell that story later in the chapter.

Expanding Terminal

The Expanding Terminal has the following characteristics:

- The pattern is rare, but when it does occur it results in a losing trade at *C* unless your trade management is carefully constructed. You end up with a losing trade because, at *C*, you will appear to have a Spring/Upthrust.
- The breakout at *D* suggests a confirmation of the change in trend, but then the market comes down to rudely awaken us by breaching *C*. As a rule, *E* is a strong, impulsive-looking swing that goes beyond *C* but then returns to congestion.
- There are new extremes at *C*, *D*, and *E*, with increasing momentum at *B*, *C*, *D*, and *E*.
- In a downtrend, *C* forms a low below *A*, and *E* forms a low below *A* and *C*. *D* forms a high above *B*. In an uptrend, *C* forms a high above *A*, and *E* forms a high above *A* and *C*. *D* forms a low below *B*.

Figure 2.28 shows an Expanding Terminal bottom.

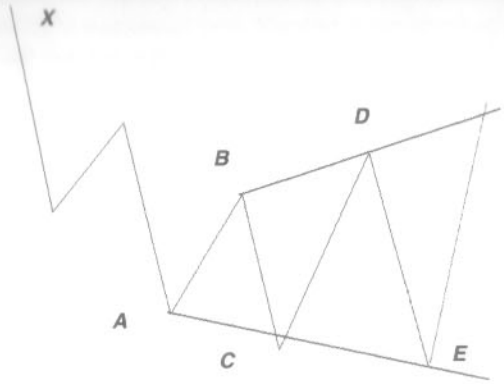


FIGURE 2.28 Expanding Terminal Bottom

Summary of Forecasting Patterns

- Forecasting patterns occur in the first lower time frame and warn of a change in trend in the trader's time frame.
- There are two types of forecasting pattern: the horizontal formations—the Horizontal Terminal and the Complex Horizontal Terminal; and the triangle termination formations—the Diagonal Terminal and the Expanding Terminal.

That completes the forecasting patterns. The next pattern to consider is the Triangle.

TRIANGLE CHANGE IN TREND PATTERNS

The difference between Triangles and the Diagonal Terminal lies in the direction of the apex. In the Triangle, the apex points to the side; in the Diagonal Terminal, it points in the direction of the trend. In addition, Triangles indicate a change in trend in the trader's time frame.

Think of Triangles as compression patterns that resemble coiled springs. When the springs finally explode, you end up with a strong directional move.

Characteristics of Triangles

Ideally, all retracements within the patterns are below 78.6% of the previous leg. This is the ideal and, like all ideals, doesn't always happen. However, one essential element *must* be present: *E* must retrace *D* by less than 78.6%.

Let's have a look at Figure 2.29, where these characteristics are evident.

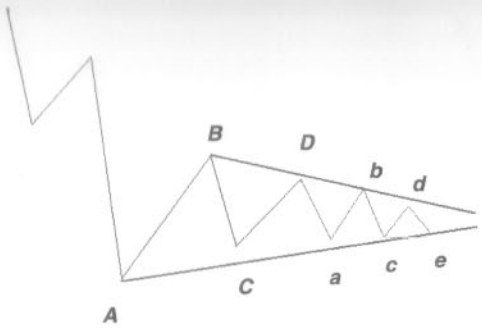


FIGURE 2.29 Triangle Change in Trend Pattern

Note:

- There are five points: A, B, C, D, E.
- The last point, E, often subdivides into five points: a, b, c, d, e. If the triangle doesn't subdivide, then E will be in place of a in Figure 2.29 and you won't get b, c, d, e.
- A, B, C, D will be seen in the time frame in which the change in trend occurs. E will often be in the first or second lower time frame.
- For example, if the triangle appears in the 18-day, then E will appear in either the 5-day or the 3-day.
- If E subdivides into a, b, c, d, e, then a, b, c, d will appear in the first or second lower time frame, and e generally will be in the second lower time frame.
- E is usually a small range day, a DOJI (a day where the open and close are about the same price), or a neutral day (the market profile equivalent of a DOJI). In short, E represents a day where there is an equal balance of power between the buyers and sellers.
- After E, we may expect an explosive move that results in a two/three-day directional move. Unless this directional move occurs, you probably don't have a Change in Trend Triangle.

Summary of Triangle Change in Trend Patterns

There are two keys to trading the Change in Trend Triangle:

1. Identify E (or e, if E subdivides). The fact that E is usually a balanced day is helpful. If you believe that you have a triangle change in trend, but fail to get a balanced day for E, look for E to subdivide.
2. Identify the day after E. It will be explosive. Don't expect the explosion to subside until at least two or three days after E.

Let's now turn to the final pattern—the Three Drives.

THREE DRIVES TO A TOP OR BOTTOM PATTERN

From one perspective we can say Three Drives to a Top is composed of a "failed" Upthrust followed by a successful one. Viewed from another perspective, Three Drives is a failed R0 that takes place at the end of a move.

Characteristics of Three Drives to a Top or Bottom

There are two types of Three Drives to a Top. The more common pattern forms, in an uptrend, higher highs and higher lows; in a downtrend, lower lows and lower highs. Its distinguishing characteristics are as follows:

- The normal rule that C won't be more than 20% of A/B *doesn't* apply, but the rule that C will be less than 10% of X/A *does*. Similarly, the rule that E won't be more than 20% of C/D won't apply, but E will be less than 10% of X/C. (By force of habit, I tend to add 20% of C/D in my charts, but I rely on 10% of X/C.)
- There is usually time symmetry between A/B and C/D.
- D will retrace between 0.618 and 0.786 of A/B.
- C will be 1.27 or 1.618 of A/B; E will be 1.27 or 1.618 of C/D.
- We begin the WPC on a breach of D after E forms. The less common variety (in fact, it's a rare occurrence) has the following elements:
  - B/D will be almost horizontal.
  - C will be less than 10% of X/A; E will be less than 10% of X/C.
  - The WPC count begins after a breach of B or D, whichever is lower, but only after E is formed.

Figure 2.30 shows the two types:

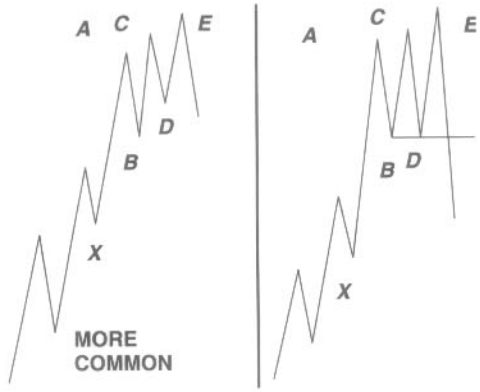


FIGURE 2.30 Three Drives to a Top Pattern

We have been speaking about Three Drives to a High/Top. The reverse will apply for Three Drives to a Low/Bottom.

SUMMARY

A downtrend is a series of lower swing highs and lower swing lows. To have a change in trend from down to up, we ultimately need to see a series of higher swing highs and higher swing lows. All the material we have covered regarding changes in trend is designed to anticipate the change.

The main tools are patterns, which anticipate the turn from higher highs and higher lows to lower highs and lower lows—and vice versa.

One rule always applies: In any change in trend can be found the first higher time-frame line change. Its one drawback is that it signals the change later than the other patterns.

Next, we turned to the Lagging Change in Trend patterns. One of these is often present whenever there is a change in trend.

The other patterns—the Forecasting, Triangle, and Three Drives—occur less frequently and as traders we need to know them so well that we'll recognize them as they form.

Now that you have covered congestions and changes in trend, consider this question: *What is the difference between a congestion and a change in trend pattern?*

The first difference is: a congestion *must not breach* any low in an uptrend. Once that occurs, I assume that the current correction is part of the first higher time-frame correction. If the uptrend resumes, I assume that the trader's time frame has begun a new impulse structure and I treat the reaction low as the starting point of the new trend.

In Figure 2.31, X, a, b, c, d, e, f represent the 5-day swings and X, A, B represent the 18-day swings. Until f, the 5-day is an uptrend, having ended its impulse move at a. At f, the 5-day uptrend ends as it has breached the low at d—that is, the 5-day uptrend for *this* impulse structure has ended and a new one has begun at f.

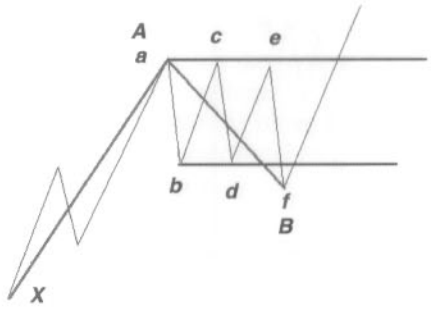


FIGURE 2.31 Correction of Higher Time Frame

In the next chapter, we will cover two essential concepts:

- the impact of different time frames; and
- the idea of acceptance.

CHAPTER 3

Acceptance, and the Function and Impact of Time Frames

In Chapters 1 and 2, we learnt to identify the trend and when it changes. In both those chapters, the concept of acceptance of price levels figured prominently. In this chapter, we study this idea and the function and impact of time frames (see the pictorial road map in Figure 3.1).

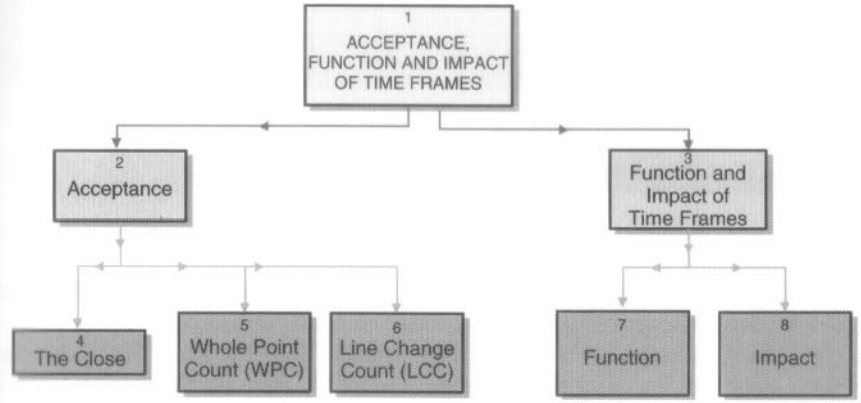


FIGURE 3.1 Pictorial Road Map of Chapter 3

ACCEPTANCE

Introduction

I learnt from Pete Steidlmayer that, with one exception, the fact that prices trade at a certain level is less important than what happens at that level (that is, rejection or acceptance). For example, compare the prices of the DJIA in Figure 3.2; in particular, compare the prices between 8,295 and 8,500. I have marked the areas with rectangles.

On both days, the market traded at the 8,295–8,500 level. Yet, there is a world of difference between the days. On August 14, I would say there was *rejection* of the level; whereas on September 3, there was *acceptance*.

You might ask: "What's the difference?" I would respond: In August, I would expect prices to head higher the next day—that is, make a higher high and higher low, and to close higher (*rejection of the level*); whereas in September, I would

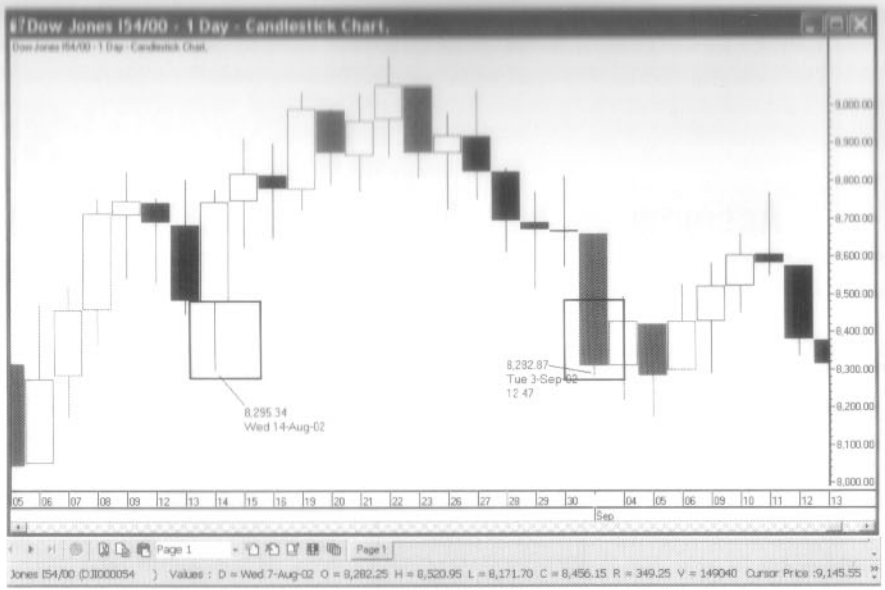


FIGURE 3.2 DJIA, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

expect the reverse—for the market to have a lower high and lower low, and to close lower (*acceptance of the level*).

I take this view because, in August, we have a long buying extreme (the area marked by the rectangle). The extreme was the result of the close being above the open and the distance of the open from the low. In September, the open was above the close and had a small buy extreme—that is, because the market closed on its lows, the distance between the close and the low was small. In short, the tools I used were the relationship between the open and close, and the magnitude of the buy and sell extremes.

The distance between the close and the open tells us whether the bulls or bears won the day:

- The open above the close is a victory for the bears.
- The open below the close is a victory for the bulls.
- The difference between the two tells of the magnitude of the victory: the greater the magnitude, the greater the probability of a follow-through the next day.
- The extremes tell us how much ground the bulls or bears lost during the day. Where the open is below the close (bull configuration), the buying extreme is the difference between the open and the low; while the selling extreme is the distance between the close and the high. Where the open is above the close (bear configuration), the buying extreme is the difference between the close and the low; while the selling extreme is the difference between the high and the open. The distance between the differences tells us how much ground the bulls or bears lost during the day: the smaller the loss, the greater the probability of a follow-through the next day.

This is what I mean when I say that it's more important to determine whether a market rejects or accepts a level, than to determine the fact that it has traded there. My one exception occurs when we assess whether an uptrend or downtrend is intact. In that assessment, any breach of a prior swing low ends that structure's uptrend, and any breach of a prior swing high ends its downtrend.

As with most things, it's easy to identify rejection or acceptance after the event. With the benefit of hindsight we are the world's greatest traders. Let me show you what I mean.

In Figure 3.3, the market has clearly rejected the low of March 12, and from that low a strong rally has ensued. But what is the difference between the rejection low on March 12 and the rejection high on June 6? In terms of the day's structure, there is no difference: the distance between the open and close for both was about the same; and each had strong rejection extremes—that is, the distance between the open and low in March 2003 is about the same as the distance between the open and the high in June 2003. Yet, in one case, the market produced a substantial rally; while in the other there was a decline of only one day before the market resumed its upswing.

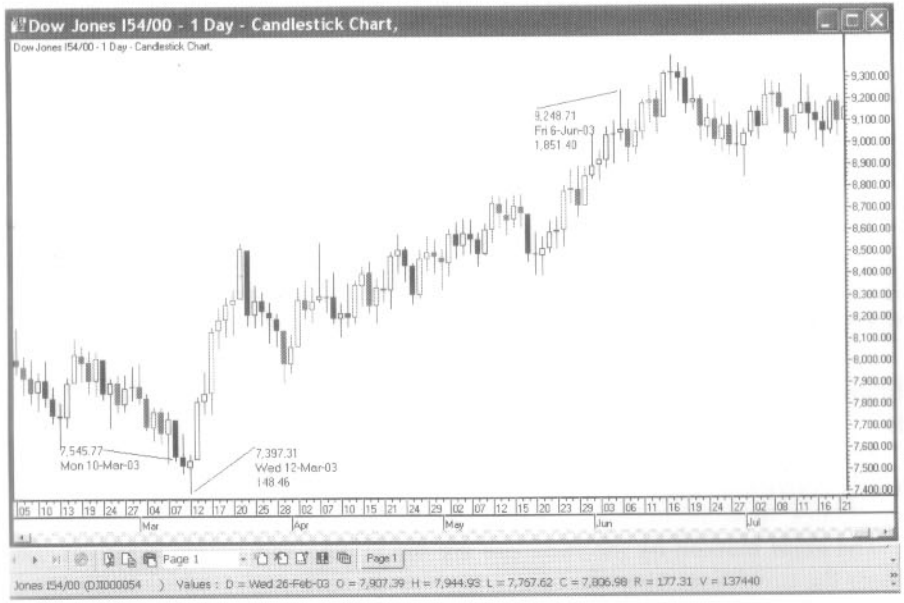


FIGURE 3.3 DJIA, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

In this section we'll consider those differences and the principles useful for our trading.

How to Identify Acceptance

As taught by Steidlmayer, daily rejection extremes are signals for the next day only. To determine whether a price level was accepting or rejecting prices, we have to know the volumes that traded at that level. We can then build a database of volume, and determine what level of volume probably leads to rejection and what level probably leads to acceptance.

Until a few years ago, few exchanges carried that information live—that is, if they carried it at all. Today, we have technology that allows us to experience the full benefits of Steidlmayer's ideas. For our present purposes, I will direct my focus to those traders who don't have access to real-time data. In this area, I have found Joseph Hart's ideas useful.

We will look at three tools: the close, the Whole Point Count, and the Line Change Count.

The Close

The primary measurement of buying or selling conviction is the spread between the open and the close. Where the open is below the close, the greater the difference between the open and the close, the greater is the buying conviction. As a rule, I like to see the open no higher than the bottom third of the range, and the close no lower than in the top third of the range. Let's consider an illustration.

Let's assume that the range is 100 points, and that the low is 1,500 and the high 1,600. There is buying conviction when the open is no higher than 1,533 and the close is no lower than 1,567.

So, now you have my first requirement for conviction: I like to see a wide spread between the open and the close. In an up bar, I want to see:

- the open as near to the low as possible, and the close as near to the high as possible;
- the open no more than one-third of the range above the low; and
- the close no less than one-third of the range below the high.

When these conditions apply, the market is indicating bullish bias for the next day.

My second requirement is: the larger the extreme, the greater the buying or selling conviction. Figure 3.4 illustrates the buying and selling extremes. (In a candlestick, these are the lower and higher shadows.)

The areas marked by the rectangle are the buying and selling extremes. To assess the conviction when the open and close are equivocal, we look at the total picture. In Figure 3.4's "Selling Extreme" candlestick, my analysis would have been:

1. Open below close with small spread—neutral.
2. No buying extreme, strong selling extreme—bearish.

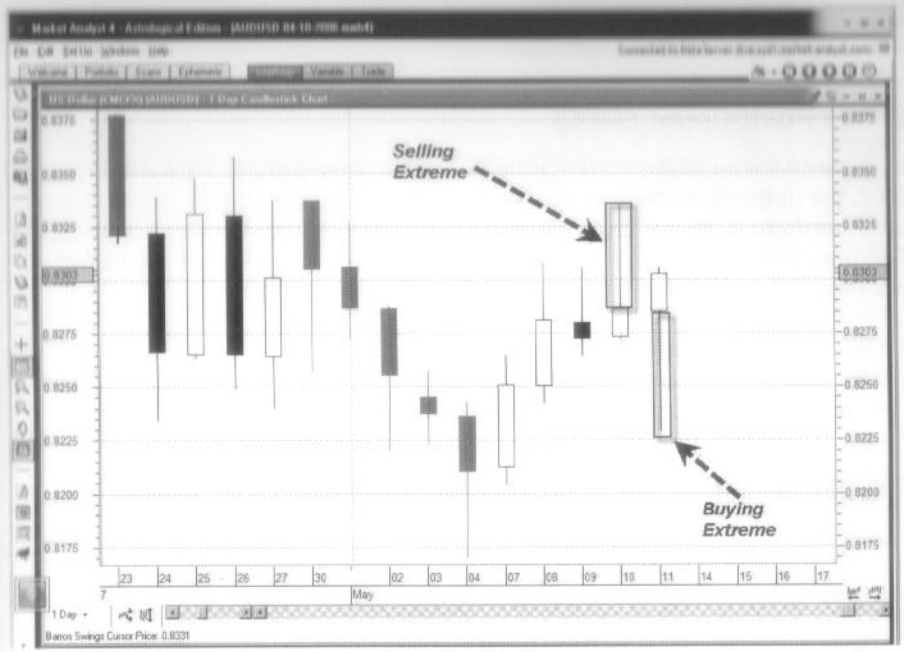


FIGURE 3.4 AUD/USD, Daily
Source: Graphics used with permission from *Market Analyst*.

3. Conclusion: The "Selling Extreme" high will hold, and the low of the day will be breached. This means the market will form a lower high and lower low. So, the next day, the market will form a down day.

I consider there is acceptance when there are two consecutive closes that demonstrate buying conviction, or two consecutive closes that show selling conviction. Unless we have the two consecutive closes showing the similar conviction, there is no acceptance.

Before we turn to the Whole Point Count and the Line Change Count, I want to address the following questions:

- *Which of these tools do we use in a trade?* The answer depends on the context. For example, I use the close when the context requires low confirmation; I use the WPC and LCC when I require more confirmation of acceptance.
- *When do I require a high level of confirmation?*

Again, the answer depends on the context. An easier question to answer would be:

- *When do I require a low level of confirmation for a 185-day change in trend?* The answer is: when I trade in the direction of the 12-month line and the 13-week trend, and the 18-day trend is in its infancy. So, I need a

higher level of confirmation when some or all of these requirements are missing.

Whole Point Count (WPC)

In Figure 3.5, the AUD/USD started an uptrend on April 6, 2001. In February 2002, the uptrend reached its zenith. From that high, the market went sideways until breakout in March 2007. The breakout point is 0.8002, the high registered in February 2004. Figure 3.6 is a zoomed-in version of Figure 3.5; the area I want to examine is the breakout in March 2007. The questions raised:

1. Do we have a WPC?
2. Do we have an LCC?
3. Do we have acceptance of maximum extension?

FIGURE 3.5 AUD/USD, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

In Figure 3.6, we have:

- the breakout day: March 23, 2007;
- the breakout point: 0.8002;
- the day the WPC completed;
- the day the LLC completed; and
- acceptance above the maximum extension (20% of *A*/*B at* 0.8248).

FIGURE 3.6 AUD/USD, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

The WPC here has yet to follow the norm. Normally, the market breaks out, re-tests the breakout point, and in the process completes the WPC. In a change in trend from sideways to up, it is important that the market not accept below the lower boundary of the Primary Sell Zone (here 0.7848) after the upside breakout. If it did, it would throw the change in trend into doubt.

This normal process illustrates why we shouldn't take a trade simply because a WPC count is complete. Normally, the count completes as the market tests the breakout point. To take a trade, the trader should look for a zone, trigger, initial stop, and risk/reward. As the market completes its re-test, it gives us time to optimize our entry.

Line Change Count (LCC)

Figures 3.6 and 3.7 allow us to examine the LCC formation.

On the breakout week, March 23, the LCC registers a reading of +1. The following week, the market exceeds the high of week 1. The boundaries of the LCC are now the high of week 2 and the low of week 1; the LCC is at +2. The following week we break above the high of week 2; the LCC is now +3.

The WPC and LCC serve to assist in determining whether the market has accepted or rejected a price level. In turn, that answer helps to answer the question: *Will the trend and/or line direction continue or change*?

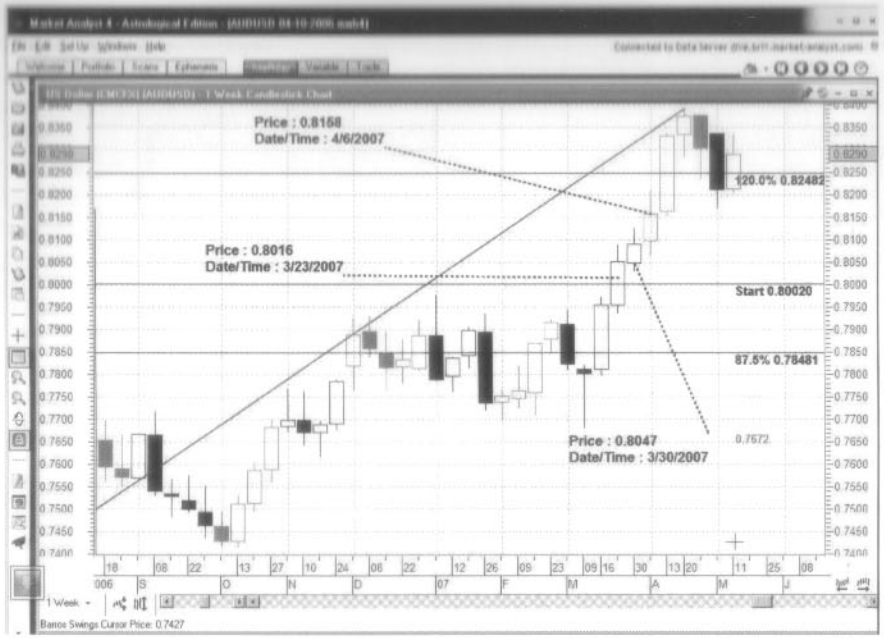


FIGURE 3.7 AUD/USD, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

Let's turn now to the function and impact of the different time frames when we seek to assess the nature of the trend in the trader's time frame.

FUNCTION AND IMPACT OF TIME FRAMES

Table 3.1 sets out the time frames from the perspective of the 185-day trader. When we consider the 185-day trend, we need also to examine the nature and state of the trend in the 13-week (first higher) and 12-month (second higher) time frames. We need to do this because the nature of their trends, especially that of the 13-week, will have an impact on the 185-day trend.

Table 3.1 Function of Time Frames

12-month Swing	13-week Swing	18-day Swing	5-day Swing	1-day Swing
SECOND HIGHER TIME FRAME	**FIRST HIGHER TIME FRAME**	**TRADER'S TIME FRAME**	**FIRST LOWER TIME FRAME**	**SECOND LOWER TIME FRAME**
perspective	perspective	strategy initial stop entry zones	trailing stop	setups and triggers initial stop trailing stop

For example: If the 13-week and 12-month are in an R2 mode, it is likely the 185-day will also have impulse waves in R2 modes as well as corrections that abort. On the other hand, if the 12-month is in congestion and has R0 moves, the 13-week impulse moves will be affected. If the 13-week is also in a sideways trend, the 185-day impulse structures will be shorter than normal. And so on, and so on . . . For this reason, it is essential that our trend examination of the 185-day include the 12-month and 13-week.

There is one other reason why we ought to examine the 12-month and 13-week. The way the 18-day and 5-day react to higher time-frame support and resistance will tell us if the resistance is likely to hold or give way.

Checklist

The following checklist may enable a trader who is unfamiliar with this approach to use his time more efficiently. For the 185-day trader, the relevant time frames and questions are:

12-month: *What is the line direction?*

Continuation or change? (This will depend on the 13-week and 185-day reactions to the support and resistance for the 12-month.)

Where are the 12-month support and resistance zones? (Their location often provides information critical to the success of a trade.)

13-week: *What is the trend?*

What is the line direction?

Continuation or change? (This will depend on the 185-day and 55-day reactions to the support and resistance for the 13-week.)

Where are the 13-week support and resistance zones? (Not as important as the 12-month, but they can play an important role.)

At the end of the first two phases, the trader has a good idea of his risk profile. The lowest risk profiles are those where:

- The 13-week trend is in its infancy and the trend is in line with the 12-month line direction.

- For long trades, the 12-month low has just bounced off support. By "just bounced off," I mean that the 13-week has given a WPC and/or a +3 LCC signal by no more than two weeks.
- Ideally, the 13-week has also given a Spring Change in Trend signal so that longs were initiated at the end of the 13-week downtrend rather than near the breakout point.

18-day: *What is the trend?*

What is the line direction?

Continuation or change? (This will depend on the 185-day reactions to the 12-month and 13-week zones, as well as the 55-day reactions to the support and resistance for the 13-week and 185-day.)

Where are the 18-day support and resistance zones? (Not as important as the 12-month and 13-week, but they can sometimes provide important information.)

Is the 18-day momentum indicating trend continuation or change?

Do we have any potential change in trend patterns unfolding?

5-day: If the current line is moving against the 18-day trend, ask questions we asked for the 18-day, as well as:

What are the 18-day support or resistance zones?

How is the 5-day reacting to them? Here we are looking for clues that will tell us if the 5-day impulse move (18-day correction is the same as a 5-day impulse move) is coming to an end.

Is the 5-day momentum indicating 5-day continuation or change in the 5-day line direction?

Are you seeing climactic volume and range? (By "climactic," I mean in the third standard deviation. This suggests a change in trend is imminent, as evidenced by a change in trend pattern.)

At the end of the checklist, you will have answers to these questions:

1. *What is the trend of the 18-day?*

2. *Continuation or change?*

The next step is to create an action plan to implement your analysis.

The final thing you need to do is to ask yourself: *What does the market have to show me to tell me this analysis is incorrect?* This last step is necessary to prevent myopia, where we see only what we want to see rather than what is happening.

SUMMARY

In this chapter we considered the idea of acceptance and looked at it from the point of view of the close, the WPC, and the LCC. We also considered a multi-time-frame approach to the questions of trend determination and whether the trend/line direction is likely to continue or change. Finally, we reviewed a checklist to enable you to use your time more efficiently.

The final chapter of theory, Chapter 4, considers derivative indicators—that is, either:

- indicators based on price action, but not the price action itself; or
- sentiment indictors.

(There is one exception—the Market Profile Advance Warning Tool. I include this tool in Chapter 4 because, together with the Trader Vic Trendline, it allows us to anticipate Normal changes in trend—that is, it allows us to initiate trades at *C*, rather than waiting for acceptance of levels beyond *B*.)

Barros Swings, the Ray Wave, and Market Profile are tools we can use to analyze the price action from the data itself. The indicators in Chapter 4 are derived from the price action—that is, we are one step removed from the price data. For this reason, I treat them as secondary tools.

CHAPTER 4

Derivative Indicators

INTRODUCTION

By now you will have gathered that I consider identifying the trend, and the change in trend, as the most important part of trade preparation. You also understand that a change in trend in one time frame is merely a correction in the next higher time frame. This distinction is particularly important if you are a responsive trader—one who buys on dips in uptrends and sells on rallies in downtrends.

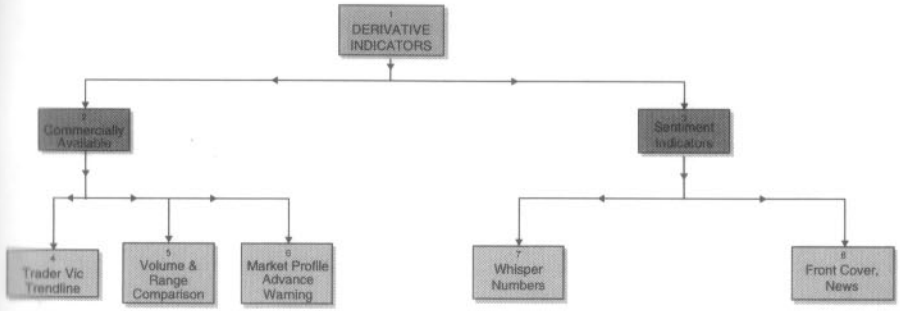


FIGURE 4.1 Pictorial Road Map of Chapter 4

But what about derivative indicators such as Wilder's RSI? Do they have a place in my toolbox? The answer is: "No." I consider the Barros Swing and Change in Trend Patterns to be primary tools. The tools discussed in this chapter are secondary tools. The distinction is important.

- A primary tool can be *the only reason* for a trade. That is, it is capable of justifying a trade on its own.
- A secondary tool increases the probability of success, but cannot be the sole reason for a trade.

For example, if I saw a Spring, I would take the trade whether or not a secondary tool were present; but a secondary tool alone, such as a Value Chart divergence, would need the support of a primary tool to justify the trade. To raise a rating from "normal risk" to "above normal risk," I would want to see more than one secondary tool supporting the primary tool.

The various tools can be classified as follows:

- Tools that are available in commercial charting packages:
  - Trader Vic Trendline;
  - comparison of volume and range between two impulse moves; and
  - Market Profile AdvanceWarning Tool.
- Tools that require subscription to a service: Sentiment Indicators:
  - WhisperNumber;
  - Bullish Consensus; and
  - Front covers of popular magazines and responses to reports.

COMMERCIALLY AVAILABLE TOOLS

Trader Vic Trendline

Construction

Construction of the trendline is straightforward.

- *In an uptrend:* Draw a line from the lowest low to the swing low *preceding the highest high.* The line shouldn't pass through any low until after the highest high is formed. If the line does cut across other swing lows, select a nearby low so that prices remain above the trendline.
- *In a downtrend:* Draw a line from the highest high to the swing high *preceding the lowest low.* The line shouldn't pass through any high until after the lowest low is formed. If the line does cut across other swing highs, select a nearby high so that prices remain below the trendline.

Let's take a look at a few examples.

Figure 4.2 shows the correct Trader Vic Trendline drawn across the lows labeled "0/1." From "0/1" the trendline remains under all other lows. Note that *X* and *D* are the actual swing lows, but that I used 0 and 1. Look at what happens when the *X*/*D* lows are used.

As Figure 4.3 shows, the trendline passes through a number of lows—after *X* and after *D*! In fact, you will find that a trendline drawn from any low other than 0/1 will cut across other lows. In this case, the only correct trendline is the one drawn across the 0/1 lows.

Application

I use the Trader Vic Trendline in conjunction with a Normal Change in Trend pattern.

A Normal Change in Trend pattern that has had its Trader Vic Trendline breached has a higher probability of proving true than one whose trendline is intact. In fact, if a Trader Vic Trendline is breached, I am willing to consider fading the extremes of the congestion rather than waiting for acceptance beyond *B*. To pre-empt the trend

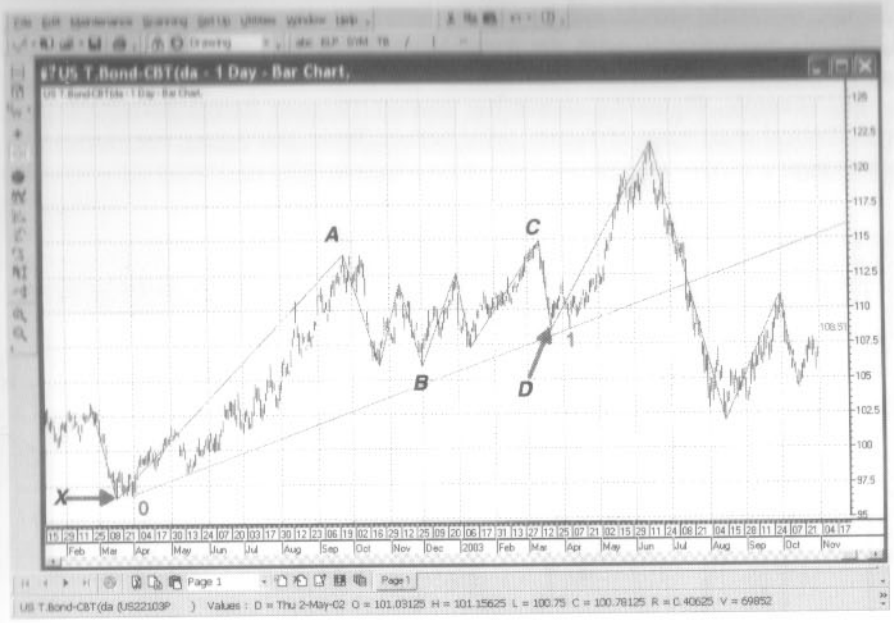


FIGURE 4.2 US 30-year Bonds
Source: Graphics used with permission from *Market Analyst*.

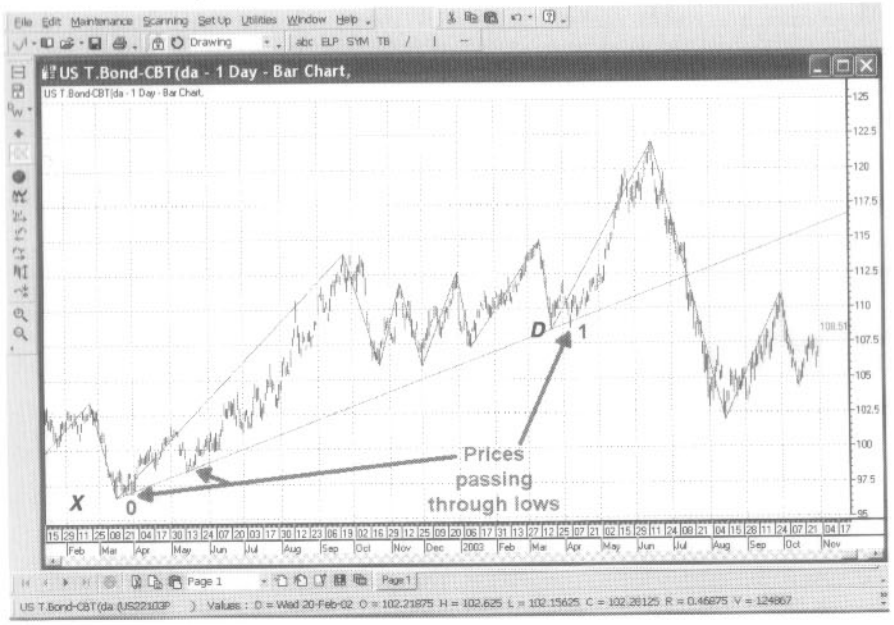


FIGURE 4.3 US 30-year Bonds
Source: Graphics used with permission from *Market Analyst*.

change, my trade would need to be in sync with the 13-week trend and the 12-month line—that is, with the first higher time-frame trend and the second higher time-frame line direction.

For example, Figure 4.4 shows the current 13-week Barros Swings with a hypothetical road map of future price action. From the figure, we derive the following:

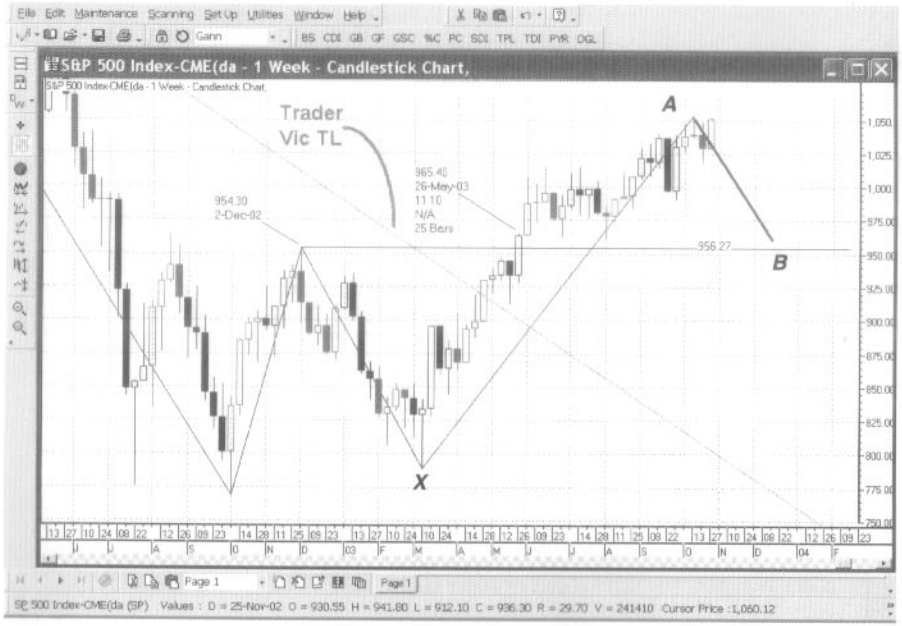


FIGURE 4.4 S&P, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

- The market has formed a Normal Change in Trend from down to up.
- After the breakout week on May 26, 2003, both the Whole Point Count and the Line Change Count completed.
- The Trader Vic Trendline was breached on May 20.

From these facts, we conclude that the 13-week trend is up.

Now, let's do a bit of crystal ball gazing. Let's assume the following:

- The 12-month line is up and looking for the 1,455–1,553 zone.
- We believe the current 13-week line direction will continue up.
- At *A*, a point sometime in the future, the 13-week line turns down.
- At *B*, the 18-day forms congestion. The question now is whether congestion is likely to evolve into a Normal Change in Trend. In short, will the 18-day congestion evolve from a sideways market into a new trend?

In this hypothetical example, at *B* we have a 12-month line direction going up, a probable 13-week uptrend, and a possible 18-day Normal Change in Trend pattern. I would wait to see if the Trader Vic Trendline is breached. If that occurred, I would be prepared to buy at the Primary Buy Zone of *A*/*B*. If the market didn't return to the Primary Buy Zone after the trendline breach, I would wait for the WPC and LCC to take a trade, or I would take one on a Wide Range Breakout.

Summary

The Trader Vic Trendline serves a useful purpose by assisting in identification of the end of corrections and of trends. Remember that an end of a correction in the trader's time frame is simply a change in trend in the first lower time frame. So, if you want to know when an 18-day correction ends, look for an end to the 5-day impulse structure.

Comparison of Two Impulse Waves

This technique compares two impulse swings where:

- you want to compare two impulse structures; and
- the ultimate swings in the first lower time frame in both structures are at least impulse mean. If both are below mean, we compare the penultimate swing, provided the swings in both structures are at least impulse mean; and
- both the trader's time frame and the first higher time frame are in an impulse structure.

Figure 4.5 illustrates the suitable conditions for using this tool.

Let's say that, in Figure 4.5, we want to compare *X*/*A* and *B*/*C*. We find that both the 18-day and 5-day are in impulse mode, and that 2/*A* and 4/*C* are both at least impulse mean. Accordingly, we can use this technique.

Figure 4.6 is an example of where the technique is inapplicable. In the figure, both the 18-day and 5-day have an impulse structure. We want to compare the 18-day *X*/*A* and *B*/*C*. We find that both the 5-day 3/4 and the 5-day 19/20 are less than impulse mean. We turn to the 5-day 1/*A* and the 5-day 17/18. We find that 1/*A* is at least impulse mean, but 17/18 is not. Thus, the technique cannot be used for the 18-day swings *X*/*A* and *B*/*C*.

Application

This technique is based on the principle that, as a rule, the last swing of a structure has less momentum than the antecedent swing. To apply this principle, we isolate

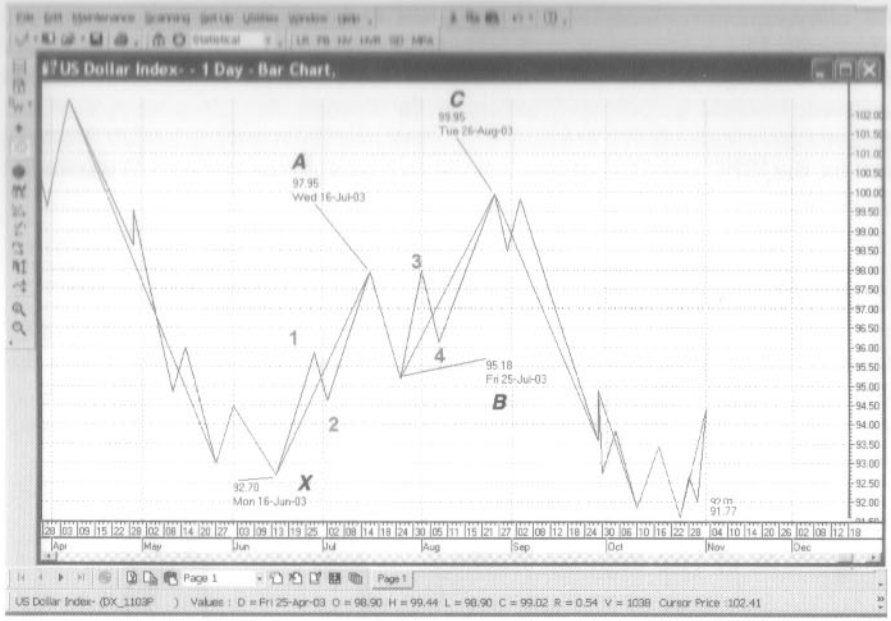


FIGURE 4.5 US Dollar Index
Source: Graphics used with permission from *Market Analyst*.

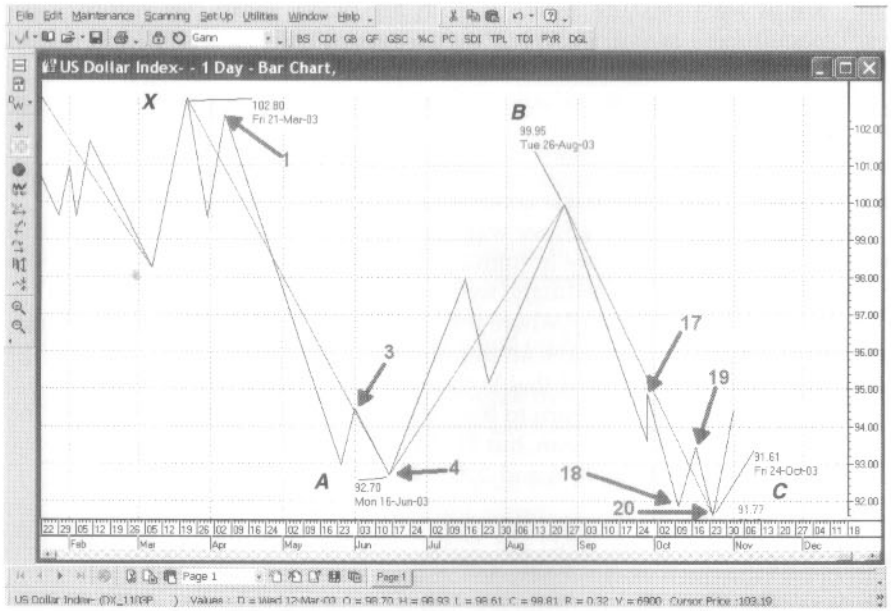


FIGURE 4.6 US Dollar Index
Source: Graphics used with permission from *Market Analyst*.

the final impulse components of two swing structures. If the second structure shows:

- a significant contraction in both range and volume; or
- a significant increase in volume, while the range significantly contracts; or
- a significant increase in volume, while the range remains unchanged,

we say that a reversal setup is in place. "Significant," in this context, means an increase or decrease of at least 30%.

Let's look at an example. In Figure 4.7, I have placed a statistical box around the 3-day swings $2/A$ and $4/C$. We find that both range and volume are at least impulse mean for both swings. Notice that while the volume has dropped significantly, the range has remained relatively unchanged:

Volume: $1{,}074/1{,}637 = 0.66$ (drop of over 30% and therefore significant) Range: $629/555 = 1.33$

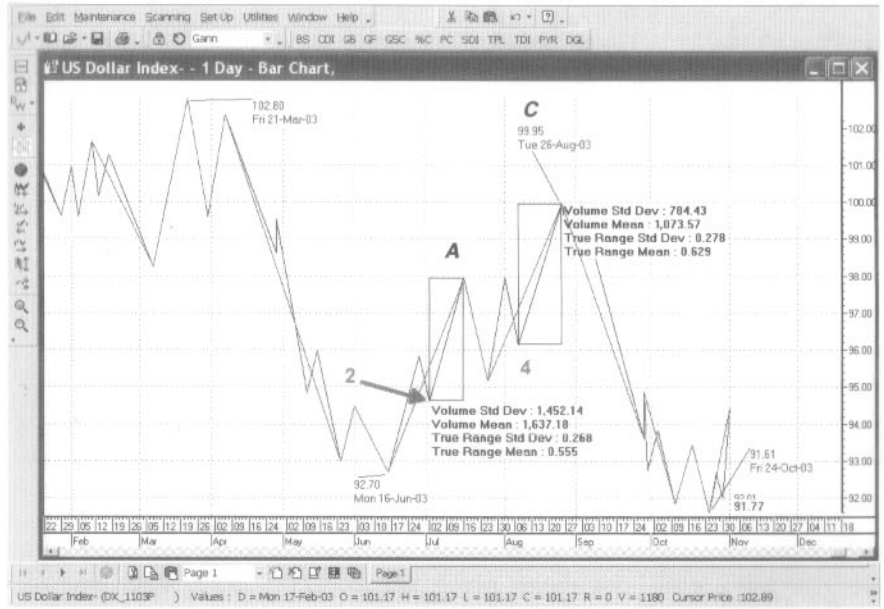


FIGURE 4.7 US Dollar Index
Source: Graphics used with permission from *Market Analyst*.

The technique is equivocal on whether the correction is likely to continue or end.

Summary

This is a useful technique when conditions are suitable for its application. It occurs most often in five-wave structures, but its restricted use makes it the least useful of the secondary tools.

Market Profile Advance Warning

The Market Profile is a useful technique that warns us when congestion will become a Normal Change in Trend.

Construction

You need a trend that is in the process of forming a congestion market. Figure 4.8 shows the situation.

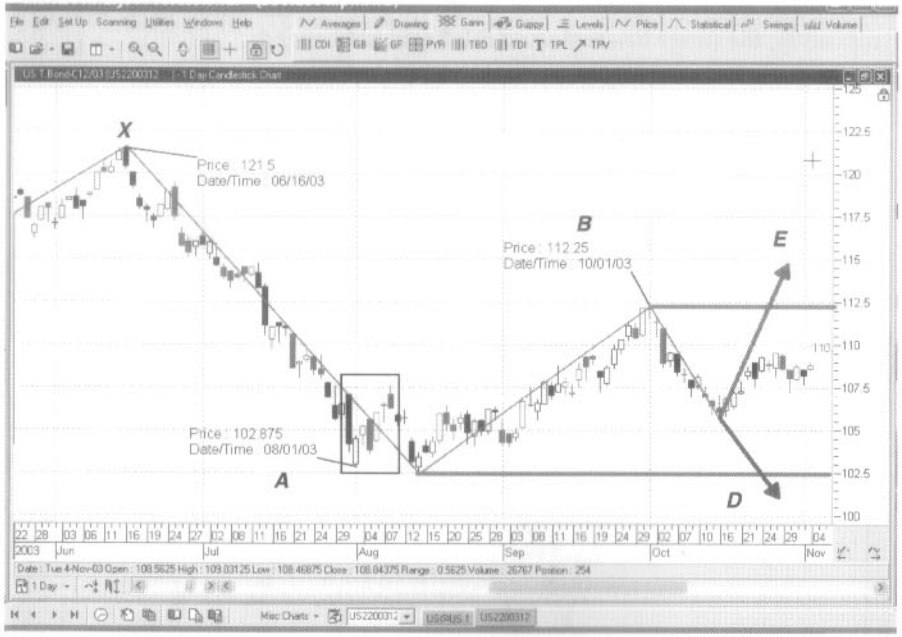


FIGURE 4.8 US 30-Year Bonds, December 2003, Weekly
Source: Graphics used with permission from *Market Analyst*.

Assume we have a downtrend in Figure 4.8 and that the latest swing is delineated by $X/A/B$. We find that the market ultimately can go to D or E. In short, will the downtrend continue or will the trend change?

The key to this technique is to identify when the directional move ended. The rectangle in Figure 4.8 marks an area where the 5-day rallied, made a new low of less than 20% of A/B and less than 10% of X/A, and returned to congestion. In other words, a directional move down in the 18-day is deemed to end *at the penultimate 5-day low*, when the 5-day rallies and subsequently makes a final low that is less than the maximum extension. In Figure 4.8, the penultimate low takes

place at A. So, in this example, the directional move began at the swing high and ended on August 1, 2003.

The next step is to calculate the time taken for the directional move. Having done that, you determine what I call the Point of Control—the price at which most of the trading has taken place. If two or more prices are equal, take the price closest to the center of the range. Figure 4.9 shows the calculation of the Point of Control.

FIGURE 4.9 US 30-year Bonds, December 2003, Daily
Source: Graphics used with permission from *Market Analyst*.

The Point of Control is 108.82: the market traded there on 22 occasions, more than any other price. "TPO" in the figure stands for "Time Price Opportunity"—that is, a time when there was an opportunity for the market to trade at a specific price.

When I first used the Market Profile, I mistakenly believed that the Point of Control was fixed. In fact, the Point of Control remains fluid as long as the market remains in congestion. Let me explain this, using Figure 4.9 as an example.

Until breakout, the Point of Control need not remain at 108.82. It can move above or below that price. Let's say that, for the purpose of this example, the next most frequently traded price after 108.82 is 105.00 (even though it is not). Let's also say that at 105.00 there are 13 TPOs. The Point of Control would change if the

market drops to 105.00 for another 10 days without breaking out of congestion and without trading at 108.82. The total TPOs at 105.00 would now be 23, and hence the new Point of Control would drop to 105.00.

Application

We use the ratio between the time taken for the directional move and Point of Control to warn us of when a change in trend is probable. I have found that the ratios imply certain consequences:

- A breakout with a ratio of less than 33.0% indicates a very strong directional move in the direction of the breakout.
- A normal ratio—that is, one that doesn't provide any information—rests between 33.0% and 78.6%, with most congestions terminating when the ratio is between 40.0% and 62.0%.
- Ratios greater than 78.6% suggest a change in trend when the market breaks out of congestion. The greater the ratio above 78.6%, the greater the probability that a change in trend will occur.

A similar concept applies to the price retracement of the directional move. The maximum retracement of an initial directional move is 50% of its range; the normal retracement lies between 40% and 50%. So, if the market retraces by that amount *and* has a directional move/Point of Control ratio of greater than 78.6%, we can expect a change in trend.

Summary

Both the Trader Vic Trendline and the Market Profile Advance Warning are useful tools. They give the trader indications of a high probability of changes in trend and/or corrections.

The ratio can be calculated manually, but most commercial packages that chart the Market Profile (multiple time frames version) will have tools that identify the TPOs at the Point of Control. By "multiple time frames," I mean software that doesn't restrict the Market Profile to any set calendar period. For example, the Market Analyst 3 software allows profiles of different days to be combined, whereas the Reuters package restricts the user to one day's data.

SENTIMENT INDICATORS

Introduction

Some readers may be unfamiliar with sentiment indicators. I first read about them in Humphrey O'Neil's *The Art of Contrary Thinking*. Most sentiment users credit him with refining the concept to the point where it became useful to traders. O'Neil, however, didn't advocate a quantifiable rating for sentiment.

In 1962, Abraham Cohen devised the first sentiment index. Dealing exclusively with the US stock market, it was called "Investors' Intelligence" and it is still available today. Cohen polled "advisory services," not traders, to obtain his ratings, as do all the services named here.

In 1964, James Sibbert began Bullish Consensus, a service for future traders. He modified Cohen's approach, including introducing a weighting to the advisory sources in proportion to the number of traders it influenced. In 1972, James Sibbert and R. Earl Hadady joined forces; then, in 1974, Hadady bought Sibbert's share. The Bullish Consensus Index, edited by Richard A. Ishida, is still available today (www.marketvane.net).

Readers interested in using sentiment as a stand-alone tool would find useful Hadady's 1983 book entitled *Contrary Opinion*, in which he provides a complete trading plan for traders who want to use Bullish Consensus as their only or primary tool.

Subsequently, a number of similar services appeared on the market—for example, Jake Bernstein's MBH Commodity Advisors produces the Daily Sentiment Index. Other sentiment measurements have recently been used:

- Phil Erlanger (www.erlangersqueezeplay.com/page/esp/) uses three tools along with the VIX Index (an index constructed from the CBOE options data). The service is available only for the US stock market.
- WhisperNumber (www.whispernumber.com) is the only service I know of that polls traders. It covers the US and international stock markets, currencies, gold, and US interest rates.

No matter how an index is constructed, the principles remain the same. The following summary is taken from Hadady's *Contrary Opinion*.

1. Rising prices and a rising sentiment index is bullish.
2. When the sentiment index reaches an extreme in a rising market, it signifies that the last buyer has bought. As the market has run out of buyers, prices can only go down.
3. A news event isn't required to start the decline. Profit taking by the exit of a handful of small traders could start the fall. A bearish reaction to bullish news is a clear signal that the extreme has been reached.
4. The reverse applies for falling markets.

WhisperNumber

Construction

At present, I find this service to be the most accurate. The authors take the view that once their numbers reach extremes, we can expect price action to follow

within five to 10 days. Since I use the index as a secondary tool, I don't know if this is statistically true.

What I *can* tell you: my trading records show that an entry signal accompanied by WhisperNumber extremes improves my bottom line by a massive 15%!

For the US stock market, WhisperNumber considers a reading of 20–25% as oversold and a reading of 49% or over as overbought. I calculated my own overbought and oversold levels based on the data they supplied. There are only 29 observations, so that any conclusions I draw about the levels are tentative and subject to revision.

My numbers are slightly different and are based on Steidlmayer's statistical approach; Figures 4.10 and 4.11 show the calculations. Note that I have focused on the third standard deviation only; and, because of the way the figures are constructed, I take the view that in assessing oversold or overbought conditions, you need to consider both the bearish and bullish readings. Figure 4.10 reflects bullish sentiment and Figure 4.11 bearish sentiment.

BULLISH SENTIMENT

Bins	Freq	% Occur		
65	1	3%		
60	1	3%		
55	2	7%	4	90%
50	3	10%		
45	5	17%	1	17%
40	3	10%		
35	3	10%	2	38%
30	5	17%		
25	5	17%	3	72%
20	1	3%		
15	0	0%		
	29	100%		

FIGURE 4.10 WhisperNumber Bullish Sentiment Calculations
Source: Data used with permission from *WhisperNumber.*

BEARISH SENTIMENT

Bins	Freq	% Occur		
65	0	0%		
60	0	0%		
55	1	3%		
50	1	3%		
45	1	3%		
40	3	10%	3	3
35	5	17%	2	62%
30	5	17%		
25	8	28%	1	28%
20	3	10%	3a	83%
15	2	7%		
	29	1		

FIGURE 4.11 WhisperNumber Bearish Sentiment Calculations
Source: Data used with permission from *WhisperNumber.*

I have overbought levels for bullish sentiment at 55 to 60, and oversold at 20 to 25.

I would expect that as the database becomes larger, the third standard deviation for bearish sentiment will readjust. As it presently stands, a reading of 19 to 15 is in the second standard deviation. I am treating that level as oversold for bearish sentiment. The overbought levels are 40 to 55.

Like oscillators, sentiment indexes can give divergent signals. Indeed, you would expect that as the market continues to make new highs, there should be fewer buyers at each new peak. My WhisperNumber database is still too small to determine if divergence will play a part in their data.

It is interesting that WhisperNumber has the US stock market at overbought levels. It certainly agrees with my view that the 13-week line should correct (see Chapter 5). Bullish Consensus, on the other hand, had the market on November 3, 2003 at 59, scarcely overbought.

It is also interesting that we have divergence for the S&P and WhisperNumber. For the period October 15 to October 28, 2003, WhisperNumber had a sentiment index of 65, signaling the market was extremely overbought; for the period October 29 to November 12, the reading dropped to 58. The S&P, on the other hand, went from 1,054 on October 15, 2003 to 1,061 on November 3. That is, higher highs on WhisperNumber, lower highs on the S&P.

Figure 4.12 shows WhisperNumber (since January 2002 to date) against the S&P. Note that I adjusted the S&P levels so that I could chart both series on the same chart. Compare the slope of the S&P with WhisperNumber, and ignore the price level.

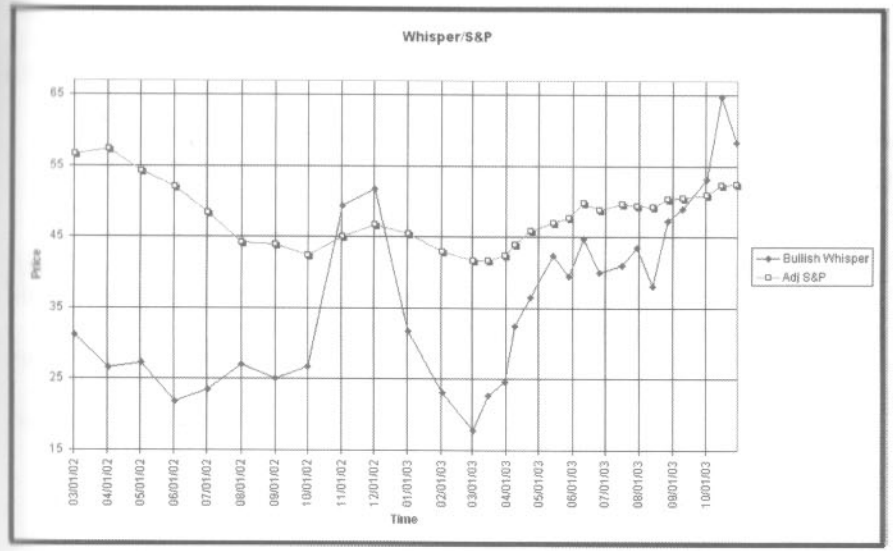


FIGURE 4.12 WhisperNumber and S&P, Cash
Source: Data used with permission from *WhisperNumber.*

Since I started using the WhisperNumber service I have been impressed with their accuracy. In statistical terms, the service is still in its infancy, so the jury is still out about its long-term accuracy. Nevertheless, the promise is there.

"Front Cover" and "Response to Reports"

Introduction

As indicators, "Front Cover" requires access only to *Time* or *Newsweek*, or their local equivalent, whereas "Response to Reports" requires access to an economic report—for example, the expected number of non-farm payrolls, the actual number, and the market's response.

In the case of both indicators, we will look at the situation where the market is trending strongly, a report comes out, and the market behaves in a manner contrary to "normal expectations" in a type of negative development setup. For example:

- *Time/Newsweek* has a cover story and front cover stating that the "US Stock Market is Stronger Than It Has Ever Been!" The public might expect the market to continue to soar, but instead there is a high probability that it will tank.

Construction

There is little to construct unless you want to keep a set of statistics, and even that isn't necessary. Watch the covers of news magazines, and make a note of the reports to which the market is reacting. This is necessary because the reports the market will respond to will change according to trader/investor perceptions of what is important.

Application

The critical factors are as follows:

1. A bull or bear structure of above-average strength.
2. For "Front Covers," if your instrument appears on the cover of *Time/Newsweek* or their local equivalent, you can expect a reaction in about three to four weeks that is contrary to the cover story.
3. For "Response to Reports," you can expect a contrary reaction to an economic report.
4. Both indicators, alone or together, generally signal the end of an impulse structure that is at least a 13-week.

Conclusion

I have always believed in sentiment indexes; my only reservation has been the way the data has been collected. Polling newsletter writers isn't the same as polling traders. Using the VIX data seems to me to be more realistic, but that is limited to the US stock market.

SUMMARY

In this chapter we have discussed a number of secondary tools, each of which has a particular use. The following is a summary of how I use these tools:

TOOL	HOW USED
Trader Vic Trendline	To identify if a sideways market will turn into a Normal Change in Trend. Use with Market Profile Advance Warning and Fisher's PHI-ellipse.
Range Comparison	Possible end of a zigzag correction. Use Sentiment Indicators, e.g. WhisperNumber.
Sentiment Indicators	Use with Barros Swings, especially "Front Covers" and "Response to Reports," and WhisperNumber as above.

So far in this book, we have focused on answering these questions:

- What is the trend?
- Will it continue or change?

The answers to these questions provide us with a strategy—that is, whether to be buyers or sellers. However, while I consider trend identification, and continuation or change, to be the most important matters for a trade, we also need to consider other areas:

- Zones: Where are trades to be taken?
- Setups, triggers, and initial stops: What do I need to see to enter a trade? What is my initial protective point?
- Trade management: How do I manage a trade once I am in a trade?

The remaining chapters of this book will look at these additional areas.

CHAPTER 5

Entry and Trade Management

INTRODUCTION

In the previous chapters, we considered the trend of a time frame and whether the trend would continue or change. In this chapter, I will examine the requirements for a low-risk entry and trade management (see Figure 5.1).

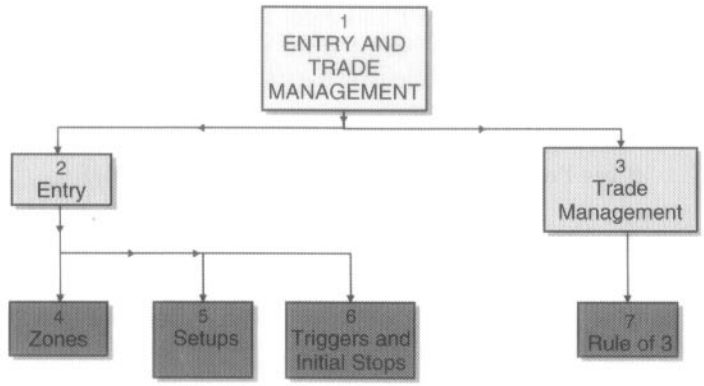


FIGURE 5.1 Pictorial Road Map of Chapter 5

Most novice traders make two critical trading mistakes:

1. They fail to consider the trend of their trading time frame, and whether it is likely to continue or change.
2. Once they have entered a trade, they fail to manage it.

In effect, newbies seek to make money without asking themselves how best to do that. Experienced traders do this by addressing the trend and management of the trade. In this way, they maximize their profitability by addressing both their entry and exit.

Newbies focus on having a high win rate. Because trading is a probability game, profits and losses are randomly distributed; on a trade-by-trade basis, the trader has no direct influence on his or her win/loss rate. Entries and exits are a wholly different matter: the trader has a direct controlling influence. In fact, the entry and exit are the only elements in a trader's trading plan that are within his or her total control.

To overcome the probability hurdle, traders can adopt one of two strategies: they can opt to be always in the market; or they can identify those conditions that produce optimal results for their trading style and personality.

In my trading, I adopt the latter course. To place the probabilities on my side, I seek certain requirements before I take a trade. Once I have determined the trend questions, the first requirement for entry is a statistical "Time and Price Window." Within that window, I look for support (when buying) or resistance (when selling) based on MIDAS and Fibonacci ratios.

The market needs to approach my zones and provide a pattern that tells me the support or resistance has proven effective. I call these patterns "setups." Once a setup is complete, I look for the entry pattern in the second or third lower time frame. Because my trader's time frame is the 18-day, my entry is based either on a daily bar or a bar based on the following formula:

Pit Session / 5

Once I determine how and where I will enter a trade, I determine where my initial stop is to be placed. I then decide if the risk/reward ratio is within my money management guidelines. I calculate the risk/reward ratio by assessing the following:

(Core Profit × WinRate)/(Initial Stop × LossRate)

Where:

- *Core profit* is the target for the "core contract profit." We will discuss the core contract profit in the section below dealing with the Rule of 3.
- *WinRate* is the historical win rate (Winning trades/Total number of trades).
- *LossRate* is the historical loss rate (Losing trades/Total number of trades).

I like to see a risk/reward ratio of around 2:1. In my own trading, I find a risk/reward ratio of 2.5:1 difficult to maintain. Historically, my risk/reward ratio is between 2:1 and 2.3:1. Each trader should keep his own set of trading results that will allow him to work out his historical risk/reward ratios.

The initial stop is the first step in the trade monitoring process. This is a quantitative step, representing a financial loss beyond which I'm not prepared to continue, and its placement is chart-based. I bypass the trade if the loss involved is greater than my money management rules allow.

In addition to this quantitative protection, I take certain qualitative steps. I will discuss these in the section on "Subsequent Trade Management," later in the chapter. In my trading, I live the quip: "If I'm trading well, I don't get stopped out." By this, I don't mean that my entries are so perfect that I don't suffer losses; I mean that I exit positions before my initial stop is triggered. This early exit usually proves to be correct, in the sense that, after the early exit, the market continues to go against me and would have triggered my stop but for my early exit.

Once a trade moves into the "subsequent monitoring" stage, the Rule of 3 comes into effect.

This, then, is the process by which I enter and monitor a trade. Let's consider each factor in detail.

ENTRY

Zones

Zones are areas of support (for long trades) or areas of resistance (for short trades). In essence, they represent the areas where I am confident a trade will prove successful. After trend identification, this is the most important focus of my analysis.

The tools I use to determine zones are:

- the statistical time and price windows;
- MIDAS; and
- Fibonacci ratios.

Statistical Time and Price Windows

This isn't the place for a full exposition of my views on the nature of statistics and probability theory. But I will say this: I don't follow textbook ideas. My approach is heavily influenced by my understanding of the current state of Complexity Theory and my own experiences in trading.

In this section, I shall present a brief summary of the methodology I use. The important thing is that it works for me—that is, it improves my net bottom line.

I have two ways of calculating the statistical time and price windows. I will explain first what I call the "quick and dirty way."

- Take a sample of at least 15 impulse moves. [Theoretically, we should take at least 40 readings, but in my experience most traders are unwilling to calculate 15 readings, let alone 40. In any event, most of the time, 15 readings will produce satisfactory results. The samples include the price ranges and the time ranges between impulse swings.
- Calculate the mean and standard deviation of the sample.

- Delete all the outliers—that is, all readings beyond mean +3 standard deviations and mean −3 standard deviations.
- From the remaining data, recalculate the mean and standard deviation.
- The values thus obtained allow me to define five conditions:

1. A normal reading, which for me means that there is a 50:50 chance that the impulse move will continue (mean +1 standard deviation to mean −0.5 standard deviation).
2. A moderately subnormal reading, which for me means that it's unlikely that the impulse move will terminate in this time frame. I look for opportunities to add to my positions on first lower time-frame retracements (mean −1 standard deviation).
3. A moderately abnormal reading, which for me means there is some probability that the impulse move will shortly be coming to an end (mean +2 standard deviations). With this reading, I tend to tighten my trailing stops, and I'm reluctant to add to new positions.
4. A significantly subnormal reading, which for me means that it is exceedingly unlikely that the impulse move will terminate in this time frame (mean −1.5 standard deviation). I aggressively look for opportunities to add to my positions in the second lower time frame.
5. A significantly abnormal reading, which for me means that it is exceedingly likely that the impulse move will shortly be coming to an end (mean +3 standard deviation). With this reading, I'm looking for opportunities to liquidate my positions.

I take sample readings in the trader's time frame, first higher time frame and first lower time frame; the readings are for both time and price, and for both corrective and impulsive swings.

So, that's my "quick and dirty way" of calculating the statistical time and price windows.

Figure 5.2 shows a snapshot of the sample collection. The charting package that I use has a tool that calculates the price and time differences between two swing points. "I" stands for "Impulse," and "C" stands for "Corrections."

Figure 5.3 shows the Excel spreadsheet with the sample data and the calculations from which I derive the mean and standard deviation data.

The time and price windows are a "wide zone"—that is, one in which the other tools will nest. An example of this is given in Figure 5.4, which shows a MIDAS (see below) nesting within a time and price window for the AUD/USD 5-period swing on 240-minute charts. By "240-minute charts," I mean charts where each bar or candlestick represents a 240-minute "open," "high," "low," and "close." The 5-period swing on a 240-minute chart is equivalent to a 1-period swing on a daily chart; it represents my first lower time frame.

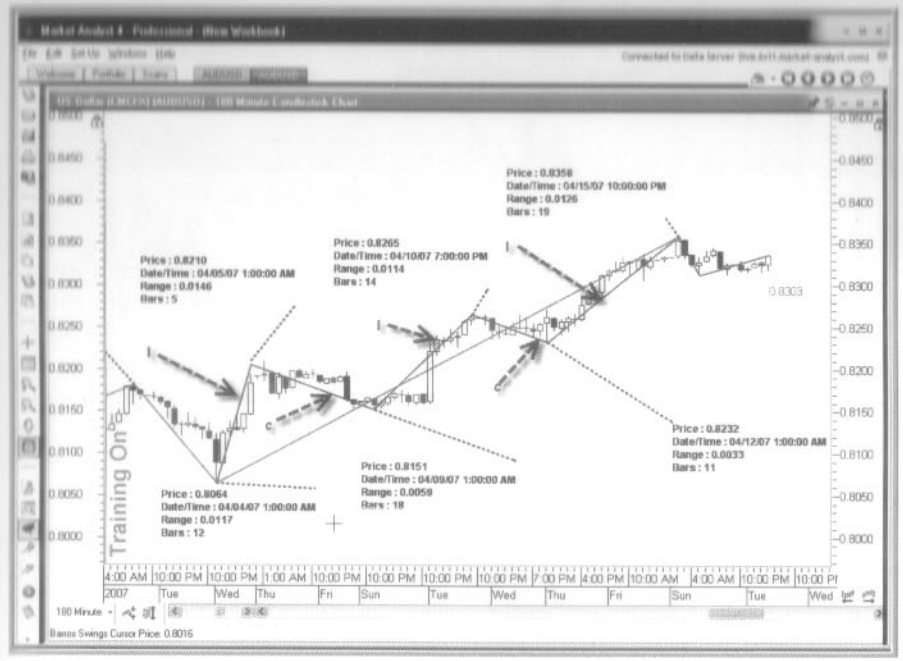


FIGURE 5.2 Sample Collection of Data
Source: Graphics used with permission from *Market Analyst*.

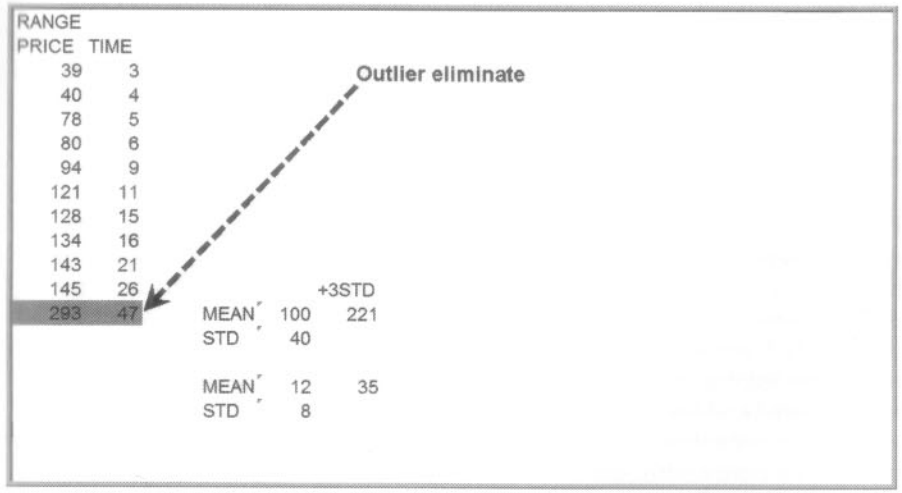


FIGURE 5.3 Excel Spreadsheet

FIGURE 5.4 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

MIDAS

MIDAS is an anchored moving average devised by Paul Levine. For a full description of Levine's work, go to: www.tradingsuccess.com/free.html. There are a number of differences between Levine's work and my own. Levine calculates a moving average based on the mid; I anchor my MIDAS from either the "high" or the "low."

So, what's so special about an anchored moving average? In what ways does it differ from a simple moving average? One difference lies in the way the moving average is calculated. In an anchored moving average, the period of the calculation continually increases. For example, on day one, the database for the anchored moving average is 1; on day two, the database is 2; on day three, the database is 3; and so on. For simple moving averages, the period of the database is pre-selected; for example, for a 20-day moving average, on the 21st day, day one is deleted and the data of day 22 is added to the database.

Another difference is the fact that the starting point of the anchored moving average is all-important; the starting point of other moving averages is when the average kicks in. For example, in a 20-day simple moving average, the average kicks in on the 20th day of data.

I start MIDAS from the swing extreme of the first higher time frame, and I keep adding MIDAS lines to each swing low. When a correction begins, I look for the closest *active* MIDAS line. To determine if a MIDAS line is active, you need to know:

- the correction swing extreme;
- MIDAS's price at the time the swing extreme is made; and
- the three standard deviations of a 45-period average true range (ATR).

To be active, MIDAS must be within 3 standard deviations of the swing extreme. For example, let's say gold makes a low at 300 and that, at the time of the low, MIDAS is at 320. The standard deviation of the ATR is 5. MIDAS is *not* active because:

- $3 \times 5 = 15$.
- Subtract the 3 standard deviations from MIDAS $= 320 - 15 = 305$.
- The low is more than 3 standard deviations away—the maximum distance for an active MIDAS is 305 and the low is at 300.

Note: Unlike other support or resistance zones, I generally like to see a MIDAS line penetrated. However, such penetration should be within 3 ATR standard deviations of the extreme. As long as the extreme is within 3 standard deviations, I consider MIDAS to be active.

Now, what about if MIDAS isn't touched? Is MIDAS active if the extreme is within 3 standard deviations but fails to touch MIDAS? If the swing extreme fails to touch MIDAS, I consider that MIDAS hasn't provided support (or resistance). In that case, I would need to see the other tools form confluence before I would be willing to consider the zone.

I have one last requirement for an active MIDAS: It has to be within 3 standard deviations of the closest statistical price window.

To summarize, three conditions are needed for MIDAS to be considered to provide support or resistance:

1. Prices at least touch MIDAS.
2. The penetration of MIDAS by a price extreme must be no more than 3 standard deviations of a 45-period average true range.
3. MIDAS must be within 3 standard deviations of a 45-period average true range of the closest statistical price window.

Figure 5.5 shows the AUD/USD 240-minute chart after the 5-period swing low formed on April 24, 2007. The 18-period corrective and 5-day statistical time price windows are shown by the small rectangle. Two arrows show the probable MIDAS supports. Remember the *active* MIDAS needs to be within 3 standard deviations of a 45-period average true range of the bar low, and within 3 standard deviations of the closest statistical price window.

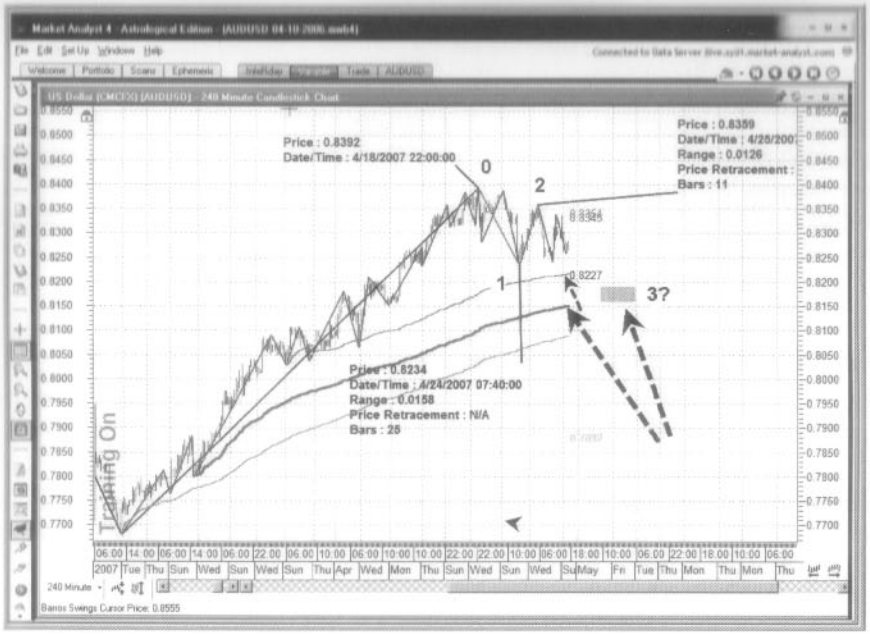


FIGURE 5.5 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

MIDAS is very important in my armory of tools for defining a high-probability zone. Indeed, only the statistical time and price windows are more important. However, it's not the only tool I rely on; I also use another tool set that I call the "Fibonacci Retracements and Projections."

Fibonacci Ratios

There are many excellent introductory books on the Fibonacci ratios, some of which are available free of charge:

- www.fibonaccibook.com/
- www.investopedia.com/terms/f/fibonacciretracement.asp
- www.earningsnow.com/fibonacci

I shall not be dealing with the introductory material; rather, in this section, I will outline the ratios that I use, as well as the swing points and time frames from which they are calculated.

I look to the ratios to provide a price window that nests within the statistical time and price window. To do this, I draw a distinction between retracements and projections: the differences lie in the swing magnitudes of the extremes, from which we will calculate the Fibonacci ratios. In the case of retracements, we are measuring the swing points of the trader's time frame; in the case of projections, we are measuring the swing points in the first lower time frames.

The ratios I am considering are identical, whether I use them as retracement ratios or projection ratios. I call this set the "Fibo Ratios Set." Figure 5.6 shows the values of the Fibo Ratios.

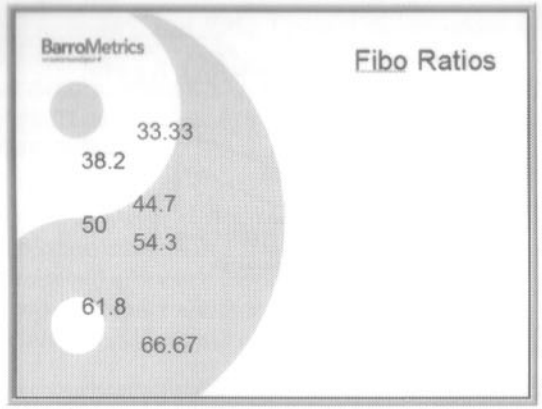


FIGURE 5.6 Fibo Ratios

To define which retracements are most likely to be met, I assess the current structure of the impulse wave. For exceptionally strong waves, I expect a retracement of at least 25% and no more than 30%. For moderately strong impulse moves, I expect retracements of between 33% and 38.2%. Where the impulse move is normal, I expect retracements of between 67% and 40%. When the impulse wave is below normal, I would expect a retracement of at least 67%, and probably 78.6% or more. The R0 structure introduced in Chapter 1 is another illustration of this idea.

The ideas expressed above are to be taken as guidelines only, because we are looking at single wave structures. A more accurate approach would be to look at the current working impulse move in relation to the whole impulse structure of the trader's time frame. For example, if I am trading the 18-day trend, in order to determine whether the current retracements will be shallow, normal, or deep I would need to consider the relationship of the current impulse swing and the whole 18-day structure.

At this juncture, it would be appropriate to examine the Fibo Ratios Set. In Figure 5.7, we meet again our old friend the AUD/USD. I have calculated the retracements using the swing points *X* and 0 (18-period swing extremes on a 240-minute chart). You will see that the levels nest snugly within the statistical time and price window.

I chose the 25% to 30% retracement levels because the preceding 18-day impulse move was very strong. Figure 5.8 shows that the 18-day swing was so strong that the 5-day didn't produce any swings in the move from the March 6 low to the April 19 high. This appears to be an R2 or R3 18-day impulse move in the offing. If I am correct in my assessment, I would expect this retracement to be no more than 25–30% of the prior 18-day impulse wave (*X*/*A* in Figure 5.8).

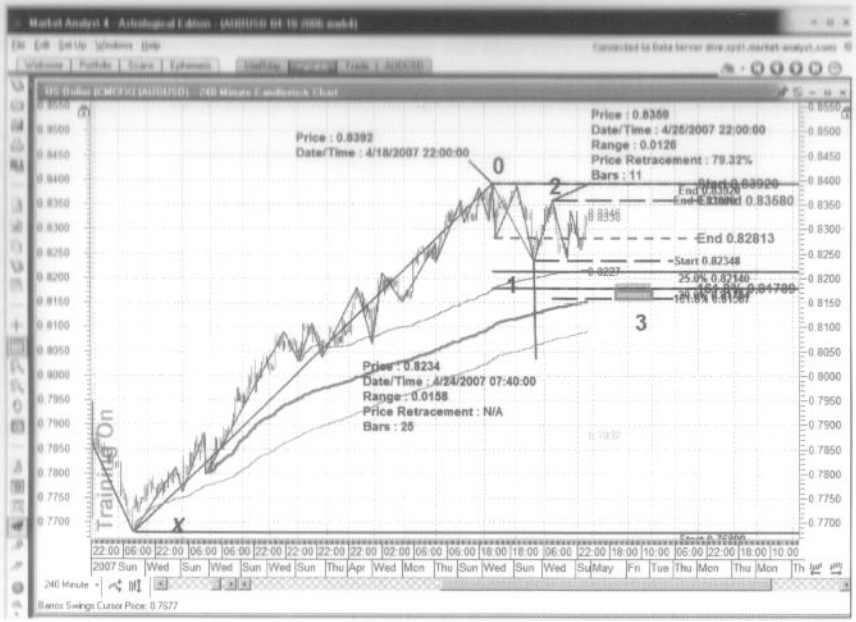


FIGURE 5.7 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

FIGURE 5.8 AUD/USD 5-day
Source: Graphics used with permission from *Market Analyst*.

Staying with the AUD/USD 240-minute chart, let's turn to Fibonacci ratios for projections; we will be projecting the ratios from first lower time-frame swing points. Again, the depth of the retracement defines the preferred projection level that will mark the end of the impulse move. If the retracement is:

- normal (between 40% and 67%), I expect the structure to terminate at the 1.00 or 1.618 levels;
- subnormal (less than 38.2%), I expect the 1.00, 1.618 to 2.618 levels; and
- above-normal, I expect the 0.618 and 1.00. Occasionally, we will see a 1.618 level.

In Figure 5.9, we see that wave −2 retraced wave −1 by 79%. Normally, we would expect a projection of no more than 1.00. However, in this case, although the 1.00 level has so far produced a bounce, because that level is not within the statistical price window, I would expect another thrust down. The 1.618 is nestled in the statistical price window and I would expect that to provide support.

FIGURE 5.9 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

Another set of Fibonacci ratios that I use is Larry Pesavento's *Harmonic Ratios* (see Figure 5.10). Again, I use swing extremes in the first lower time frame.

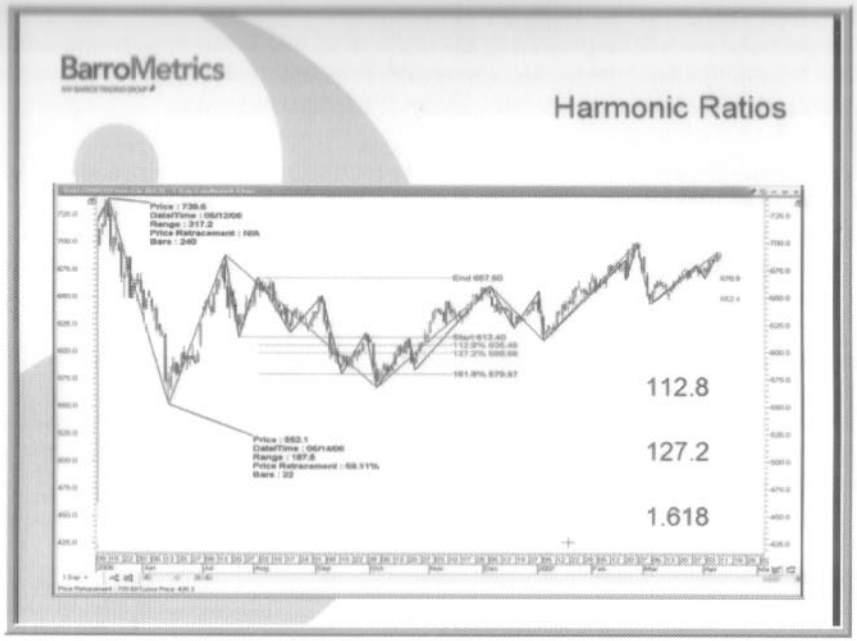


FIGURE 5.10 Harmonic Ratios
Source: Graphics used with permission from *Market Analyst*.

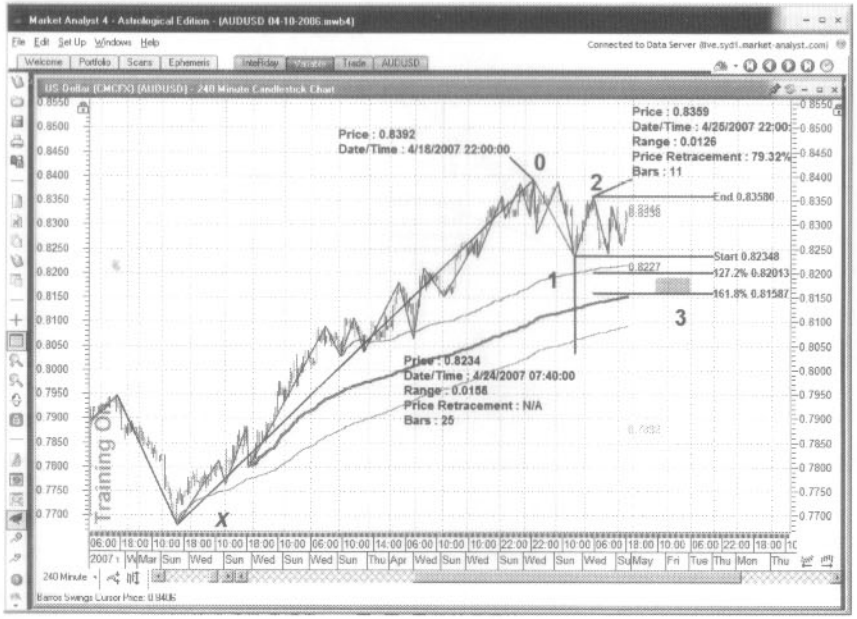


FIGURE 5.11 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

To project wave −3, we use the length of wave −2, multiply it by the ratios, and project the result from the end of wave −2. In using the Harmonic Ratios, my general principle is: the deeper the correction, the more likely it is that the 112.8 and 127.2 will provide the zones. The ratio 1.618 is the maximum I use for this set.

Figure 5.11 shows that 1.618 Harmonic Projection is the one that nudges the statistical price window, so I would use that projection in preference to the 127.2.

Let's put all that together:

- the statistical time and price window;
- MIDAS;
- Fibonacci retracements in the trader's time frame;
- Fibonacci projections from the first lower time-frame swings; and
- Harmonic Ratio from the first lower time-frame swings.

Figure 5.12 shows the composite zone bounded by a rectangle. The zone begins at 0.8150 and ends at 0.8180. The time window begins at 10:00 a.m. on May 2, 2007 and ends at 10:00 p.m. on May 7 (GMT).

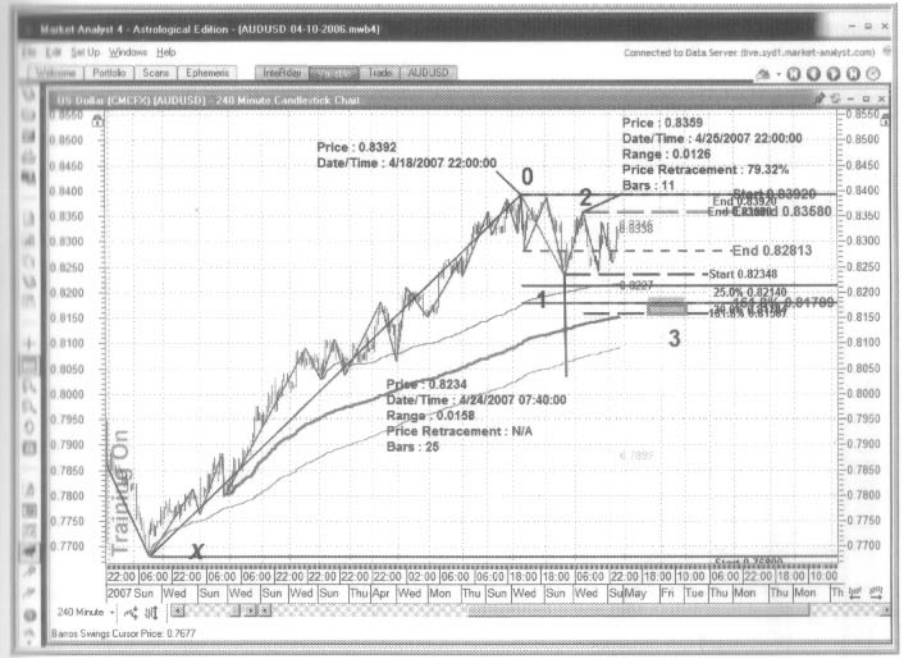


FIGURE 5.12 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

Once a zone is determined, I wait for the market to enter it. If it does, I look for either of two types of setups:

- negative development; or
- contraction.

Setups

Negative Development

What is negative development? It can be described as follows: instead of the market continuing in the direction indicated by a robust pattern (that is, a pattern that has proven dependable in the past), it does the opposite.

Most patterns are of a genre that involves a breach of support or resistance, with a failure by the market to continue in the direction of the breach. For example, a "failed head and shoulders" pattern involves a close beyond the neckline that is followed by a resumption of the trend.

The rationale behind the setup resides in the fact that markets are fractal. The robust pattern forms because the first higher time frame corrects. The "failure" occurs when the first higher time frame resumes its trend. The Spring or Upthrust is another example of this genre. Where a Spring or Upthrust takes the form of a continuation pattern, I call it a "313-Outside."

Figure 5.13 is an example of a "313-Outside" negative development setup. The swing you see is the 18-day (the monthly trend). The first higher time frame, the 13-week (the quarterly trend), is in an uptrend; in Figure 5.13, this is the thicker swing line that is still at the 0.7978 high that was formed on January 3, 2007. The 18-day line turned down and then up on January 30, 2007 at 0.7695.

FIGURE 5.13 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

On March 6, 2007, the market makes a new low at 0.7677, taking out the previous low at 0.7695 (Figure 5.14). At the same time, the move to the 0.7677 turns the 13-week line down, completing a corrective move.

FIGURE 5.14 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

Normally, we would expect that upon breach of support the market would continue heading south. Instead, as Figure 5.15 shows, the market returned to the

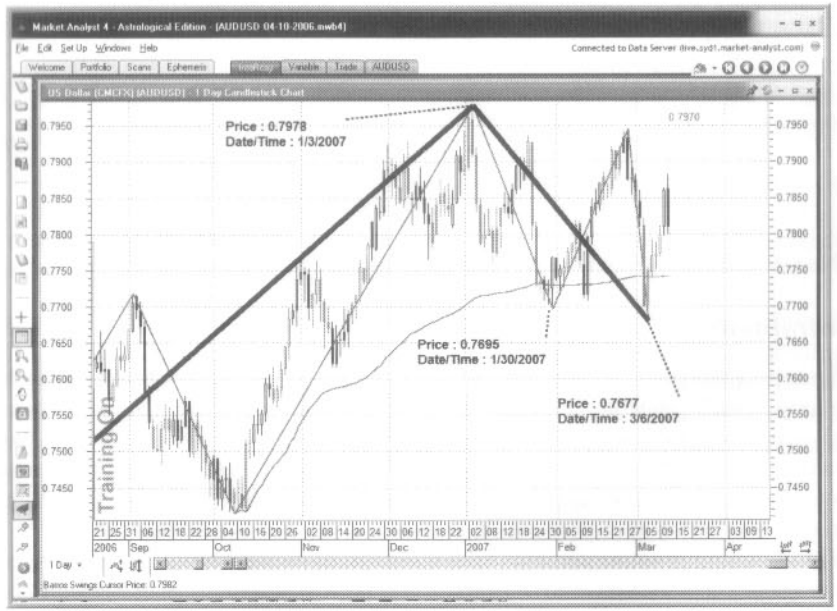


FIGURE 5.15 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

congestion formed between 0.7978 and 0.7695. This price action illustrates my "313-Outside" negative development pattern.

Another form of negative development is the big bar with no follow-through. In this case, the market first forms a strong directional bar. Normally, we would expect no more than one pause day before the market resumes the directional move. Instead, the directional move marks the end of the correction and the beginning of the resumption of the higher time-frame trend. Figure 5.16 uses an example of this setup: the big-bar day occurs on January 1, 2006.

FIGURE 5.16 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

Negative development is one type of setup; another is contraction.

Contraction

In the contraction setup, there is a decrease in the range as the market approaches the zone. Ideally, on the day that the market reaches the zone, it will form a small-range neutral bar—that is, a bar where the open and close occurs at about the same place and where the range is below normal (that is, is less than mean −1 standard deviation of the 45-period average true range, or ATR). Figure 5.17 is an example of a contraction setup.

The contraction setup can also take the form of neutral bars. The ranges may be normal, or moderately above normal, but the open and close are close to one another (within 0.5 of a standard deviation of a 45-period ATR).

FIGURE 5.17 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

The setup can also take the form of the *smallest range of the past four days* (usually called NR4) or the *smallest range of the past seven days* (usually called NR7), or you can have an inside day that forms the smallest range of the past four or seven days (usually called IDNR4 and IDNR7, respectively). Each level of contraction increases the probability that the zone will hold and an explosive move will follow in the direction of the trader's time-frame trend.

The arrow in Figure 5.17 points to a neutral bar. Note that the open and close were at the same price.

Contraction setups can also be spotted with indicators. Robust indicators found in most charting packages are:

- *The Keltner channel coupled with a Bollinger band channel.* I set the Keltner to a standard deviation of 1.5 with an 18-day moving average. I set the Bollinger band to a standard deviation of 2.0 with an 18-day moving average. Normally, the Bollinger bands will be outside the Keltner channels, but in periods of low volatility the bands will be within the Keltner channels. This is a warning of a large move to come.
- *The historical volatility ratio.* This is the ratio between two different lengths of historical volatility (for example, the ratio between 5-day and 100-day historical volatility). The 0.5 zone is used as the benchmark. When the market drops below 0.5, near-term volatility is signaling that a large move is to come.

- *Bollinger bandwidth.* This is the width of the bands expressed as a percentage of the moving average. When the bands narrow drastically, a sharp expansion in volatility usually occurs very soon after.

Figure 5.18 provides examples of each of these indicators. In the top pane we have the Keltner and Bollinger bands. The Bollinger bands have just dipped into the Keltner channels, suggesting a large move is about to occur. The second pane is the historical volatility ratio. The indicator is well above 0.5; there is no shrinking of volatility here. The final pane is the bandwidth. The market is close to the historical lows, suggesting we are close to a large move.

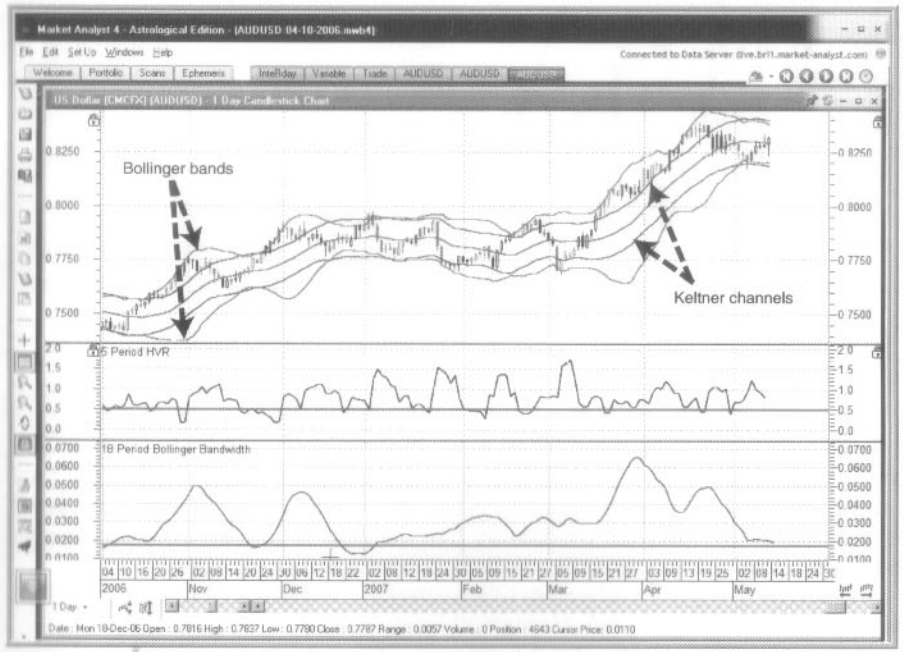


FIGURE 5.18 AUD/USD, Daily
Source: Graphics used with permission from *Market Analyst*.

Once we have a setup in place, I look for an entry and the placement of the initial stop. Let's now turn to that subject.

Triggers and Initial Stops

Triggers

The triggers for negative development setups are setup-specific. I look for a resumption of the next higher time frame's trend. For breaches of support or

resistance, I look for an acceptance beyond the primary zones of the previous congestion. For the "big-bar no follow-through," I look for a breach of the price that is 10% of the big-bar's range above or below its extremes.

The trigger for contraction setups is any bar that shows conviction in the direction of the higher time-frame trend.

Figure 5.19 provides examples of the various triggers. At *A*, we have a contraction trigger; at *B*, we have a "negative development breach of support" trigger; and at *C*, we have a "big-bar no follow-through" trigger.

FIGURE 5.19 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

Zones, setups, and triggers get us into a trade. We now turn to the exit strategies.

Initial Stops

I separate exit strategies into:

- initial trade monitoring; and
- subsequent trade monitoring.

Initial trade monitoring can be quantitative or qualitative in its approach. The *quantitative approach* represents a price beyond which I am not prepared to accept further loss. The stop placement is determined by the structure of the market, and

the potential loss is vetted by my money management rules. Unless my potential loss is within my money management structure, I would bypass the trade.

I have three types of initial stop loss placements. In order of preference, they are:

- beyond the maximum extension;
- beyond 10% of the current swing; and
- if the entry bar shows strong conviction, beyond the extremes of the entry bar by 10% of its range.

The stop placement has to balance the amount of dollar loss with a probability that the market will hit the stop and then proceed in our favor. Placing the stop beyond the maximum extension ensures the greatest probability that the stop will be elected only if I am wrong about the trade. The other two stops provide a measure of protection; however, even if they are hit, the probability remains that I was right about the trade but simply made an error in my timing of the entry.

Figure 5.20 shows the three types of stop locations.

- A = below maximum extension;
- B = below 10% current swing; and
- C = below 10% of low minus 10% of entry bar's range.

That is the quantitative protection; as I said, the stop represents the maximum dollar loss that I am prepared to bear for the trade.

FIGURE 5.20 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

The *qualitative protection* allows me to exit the trade before my stops get hit, thus maximizing my profitability. For example, at the time of writing (May 13, 2007), my profit for the month stands at US$118,450 and my loss for the month is US$10,350. This sort of dollar win/loss ratio wouldn't be possible if I exited the losing positions on a stop-only basis.

Before I put on a trade, I ask myself three questions:

1. What does the market have to look like tomorrow for me to remain in this trade?
2. What does the market have to look like tomorrow for me to exit this trade?
3. What is the time stop for this setup?

The answers to questions 1 and 2 are a function of context and experience. Generally, on a negative development setup, I like to see the market has moved immediately in my favor; that is, I want to see the market move by mean +1.5 standard deviations from entry within three trading days/periods (where the entry day/period is day/period 0).

To understand why I look for this, we need to understand what occurs in a negative development event. When a market breaches previous support or resistance, what generally occurs is a flushing out of all stops. Often, the market also flushes out the "weak hands." In addition, new positions are instituted by those who believe that in a trend the best strategy is to sell new lows and buy new highs.

When the market returns to the previous congestion, we have pressure from two sets of participants: the first pressure comes from those who have just instituted new positions. More likely than not, their stops on the fresh positions will be elected as soon as the market crosses the Primary Zones. The other pressure will come from those who have just been stopped out (the "weak hands"); they will feel the need to re-enter the market.

The result of these pressures is usually a quick move in my direction immediately after entry. Figure 5.21 shows the usual pattern after a negative development setup. The entry bar would have been the bar closing above the Primary Buy Zone. Immediately following the entry bar, the market moved up for six consecutive days.

I have described a generic price action that follows a negative development setup. It still has to be modified by the patterns specific to an instrument. For example, the price action described suits the foreign exchange currencies, but it is entirely a different story when it comes to soybeans. In that instrument, after a negative development setup, the market often meanders for some time before it starts the move. However, once it starts to move, it moves with a great deal of urgency!

We have just covered what I like to see following a negative development setup. Let's now turn to contraction setups.

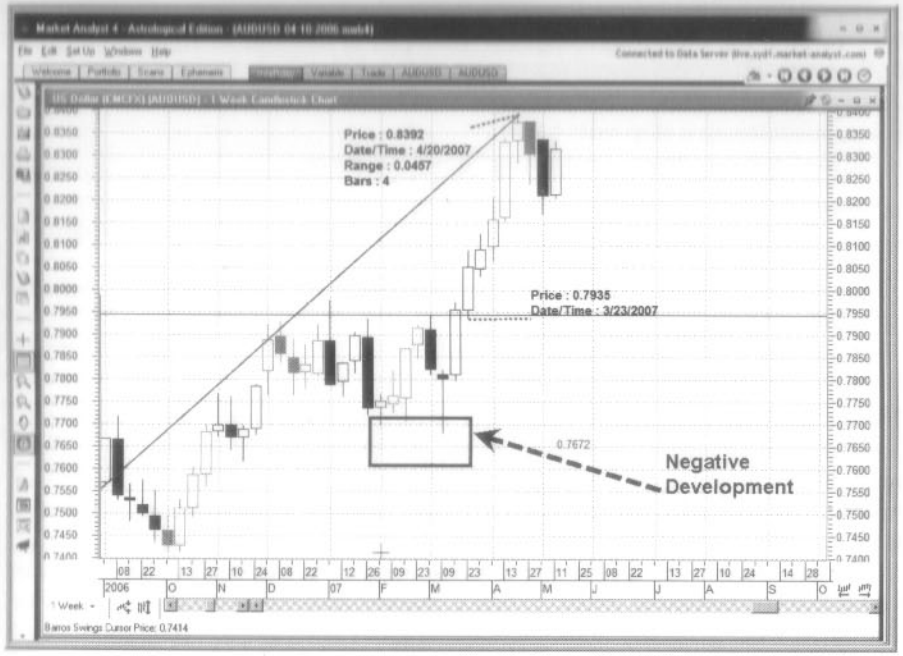


FIGURE 5.21 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

For contraction setups, we have less definite guidelines. If the contraction setup is based on tools such as the NR4, NR7, or the Historical Volatility Ratio (HVR), then I like to see a move with conviction within three to five days of entry. On the other hand, I have no specific pattern to exit the position. I rely on my time stops for early exit in contraction setups and the market's reaction to support and resistance. The next qualitative question I ask myself is: *What does the market have to look like for me to exit the trade?*

In a negative development setup, I prefer not to see a strong move against my entry until the impulse move has moved in my favor by at least mean −0.5 standard deviation. Should I see a counter entry move before the market has moved this distance, then I'm likely to reduce my exposure or cut my entire position. The rationale is simple enough: since I'm expecting a strong impulse move to commence, any strong contra move prior to at least a normal impulse move throws my analysis into doubt.

In a contraction setup, I look for market action at support and resistance levels. If I'm long, I would be looking for resistance levels to give way; and if I am short, I would be looking for support levels to give way. In other words, to determine early exit in this context, my most important indicator is the manner in which the market approaches and reacts to support and resistance.

The final question I have to answer is: *What is my time stop?*

Generally speaking, negative development setups must reach 1.5 ATR within three trading days after entry (where entry day is counted as 0). In contraction setups, my time stops are half the value of the trader's time-frame swing. Again, these are guidelines only and are subject to qualification by particular instruments' price behavior and patterns.

SUBSEQUENT TRADE MANAGEMENT: RULE OF 3

Subsequent trade management is governed by the Rule of 3. Let me say from the outset that the function of the Rule of 3 is to stabilize my equity curve; it doesn't necessarily improve my overall profitability. Indeed, in strongly trending markets, the Rule of 3 will have the effect of dampening my profits. However, I find the advantage of stabilizing my equity curve far more important than the theoretical probability of increasing my profits. A further advantage of the Rule of 3 is that it enables me to pyramid *safely* in strongly trending markets.

The Rule of 3 has four principles:

1. Trade in multiples of three contracts.
2. Exit the first position as soon as the realized profit covers the stop of the two remaining positions. For example, you are long gold at US$300 and you place a stop at US$298. Hence, your potential loss on two contracts is US$4. When the market moves to US$304, liquidation at that price would ensure you wouldn't lose on the trade even if the market now stopped you out on the remaining positions.
3. Exit the second contract at a logical objective. This second contract I have called the "core profit contract." I use this contract to assess my risk/reward—that is, I measure my stop loss against this contract's potential profit to assess my risk/reward.

   When it comes to determining the logical objective for the core profit contract, I draw a distinction between setups and zones in the trader's time frame and setups and zones in the first lower time frame.

   For the trader's time frame, the logical objective is the opposite primary zone. For example, if I have bought around the Primary Buy Zone, I would exit the core profit contract at the Primary Sell Zone.

   For the first lower time frame, the logical objective is twice the stop loss. For example, if I bought gold at US$300 and had a stop loss on three contracts at US$298, my risk on the three contracts would be US$12. In this case, my core profit contract would have a logical objective of US$12 + US$300 (my entry price).
4. The third contract is what one of my students called the "blue sky contract." The contract is designed to capture breakout moves that fail to retrace before moving exponentially. Generally, the market fails at the

Primary Zones; and, at those times, we can expect the market to stop us out at breakeven. However, it's the occasions when the market does move exponentially that more than make up for those when the third contract is stopped out.

Trailing Stops

I use a form of trailing stops that are based on the structure of the market, rather than on some mathematical criterion. In addition, there is a difference in the trailing stop formulation, depending on whether I'm using the 18-day or 5-day zone.

Second Contract

Eighteen-day zone

My stops on all open positions remain at breakeven until the market accepts above/below the 66.7% (33.33%). Once this occurs, I bring my stop on the second contract beyond the opposing 33.33% level. The stop on the third contract remains at breakeven. For example, I have bought the market at the Primary Buy Zone. When the market accepts the 67% retracement level, I bring my stops on the second contract to under the 33.33% level. When I take the profit on the core profit contract, I move my stop to breakeven on the third contract.

Five-day zone

My stops remain unchanged until I take my profit on the core profit contract. Once that occurs, I move my stop on the third contract to breakeven.

Third Contract

My desired outcome is to remain with third contracts until the trader's time frame's structure has a high probability of terminating. This will occur when the first higher time-frame line turns. I determine the probability of the higher time-frame line turn by reference to where the impulse move stands relative to its mean +3 standard deviations. Remember that once the impulse move is at or greater than mean +3 standard deviations, we have a high probability of a line turn; this, in turn, means I shall take aggressive steps to protect and/or liquidate my positions.

Along the way to mean +3 standard deviations, my trading stops tighten as the market moves along the impulse structure. At mean −0.5 standard deviation, I give the market more room to retrace than when the impulse move is at mean +2. Here are my guidelines:

- *At mean −0.5 or less,* my stop is either at breakeven or the last cleared trader's time-frame extreme. The key here is to give the market room to move.

  Note: A last cleared 18-day extreme occurs when the market has accepted above the maximum extension of the prior 18-day extreme. Figure 5.22 illustrates this idea. I moved the third contract stop to break when the market moved to the Primary Sell Zone between 0.5392 and 0.4775. When the market advanced past 0.5909, the low at 0.5222 represented the cleared low. Once the market accepted above the maximum extension of 0.6167 and 0.5870, then the 0.5870 low would have been the last cleared low.

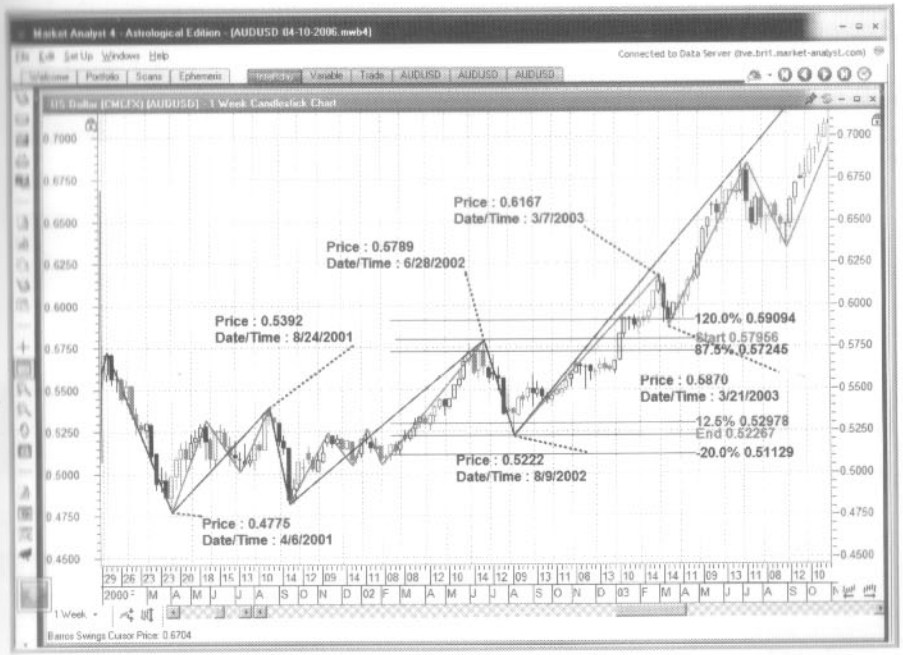


FIGURE 5.22 AUD/USD 5-P 240-minutes
Source: Graphics used with permission from *Market Analyst*.

- *At greater than mean +1 but less than mean +2:* When the first higher time-frame impulse move has traveled greater than mean +1, my trailing stop goes to beyond the second-last cleared extreme of the first lower time frame.
- *At greater than mean +2 but less than mean +3:* When the impulse move of the first higher time frame has traveled greater than mean +2, I move my trailing stop to the last cleared extreme first lower time frame.
- *At greater than mean +3:* When the impulse move of the first higher time frame has traveled greater than mean +3, I move my trailing stop to the second-last cleared extreme of the second lower time frame.

The above are all guidelines only. The basic operating principle is to allow the market the room it needs to fluctuate prior to its line change, while optimizing your exit just before the change of its line direction.

SUMMARY

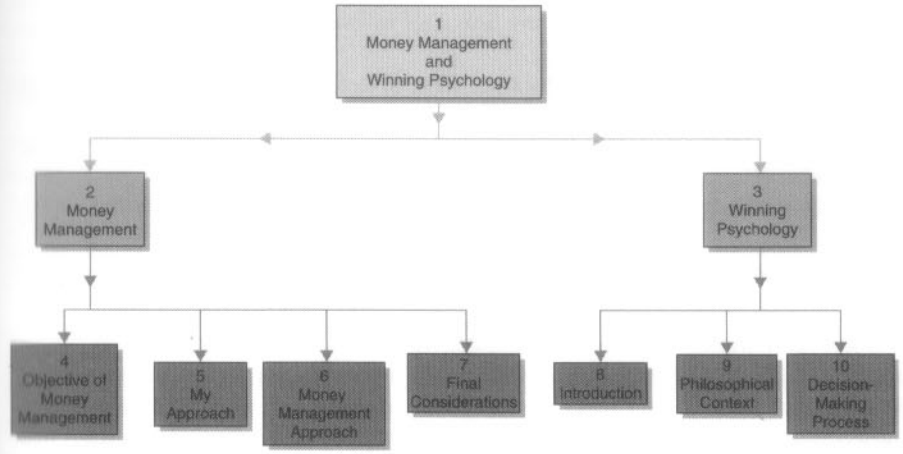
In this chapter we have considered the elements of low-risk entry and trade management. The key idea is to enter the market when the probabilities favor the trade and to maintain the position for as long as the probabilities continue to be favorable. When the probabilities turn against the position, we seek to exit, or at least to protect the position, so as to maximize profitability and minimize the loss of profits.

For low-risk entry, we look for zones, setups, triggers, and initial stops. For trade management, I employed the Rule of 3.

In the next chapter, I will show how to draw together the various strands in order to take advantage of low-risk, high-profitability opportunities.

CHAPTER 6

Effective Money Management and Winning Psychology



INTRODUCTION

Effective Money Management and Winning Psychology have a place in every trading book; and this is no exception. Indeed, these topics ought to be the subject of their own book. Why should this be the case?

In the success formula:

Winning Psychology × Effective Money Management

× Plan With An Edge

Winning Psychology represents 60% of the equation and Effective Money Management 30%. So it is tempting to think that we can succeed without a Winning Plan With An Edge. In recent literature, I have read gurus who believe that random entry and exit will make money as long as we have Winning Psychology and Effective Money Management. In my view, nothing could be further from the truth.

MONEY MANAGEMENT

A plan without an Edge that is executed with proper money management will allow us to survive the game a little longer, or perhaps a lot longer. But money management alone will not turn a plan without an Edge into a winner. Notice that the formula contains a multiplication sign between each of the elements so that a zero for any of the elements will mean that the total is zero.

What is this "Edge?" It is a Winning Plan that, over a large sample size, gives us a return of capital greater than $1 for every $1 of risk. The edge is calculated with the formula:

$$\textbf{(Average \$ Win} \times \textbf{WinRate)} - \textbf{(Average \$ Loss} \times \textbf{LossRate)} = >1$$

Where:

- The Average $ Win is the total number of dollars won divided by the total number of winning trades.
- The WinRate is the total number of winning trades divided by the total number of trades.
- The Average $ Loss is the total number of dollars lost divided by the losing trades.
- The LossRate is the total number of losing trades divided by the total number of trades.

Successful traders know that focusing on raising the WinRate for position trades to more than 60% is an exercise in futility or better left to those trading geniuses that inhabit the earth on rare occasions. For mere mortals, like you and I, a WinRate of 45% to 55% is what we can expect to achieve. The difference between the losing newbie and the experienced successful professional is the difference between the average dollar win and the average dollar loss. For most professionals, this difference can be as much as 3:1 and 4:1. In this way, we can have a hit rate of 45% and still have an excellent return.

That gives you the Expectancy Return, which is a function of a Winning Plan.

So, what is the function of Effective Money Management?

It is to balance the opposing aims of maximizing profitability on our capital and preventing the risk of ruin. The risk of ruin means losing so much money that we can no longer be in the game. Most newbies fail to appreciate the importance of risk of ruin; yet its appreciation is paramount to our success. If we have US$100,000 to invest and we risk only US$100 per trade, then we are underutilizing our capital. On the other hand, if we were to risk the whole US$100,000 each time we traded, then sooner or later, we will suffer ruin.

Objective of Money Management

To get a clear idea of the balancing act in money management, you need to ask these questions:

- What is the maximum amount that I should risk per trade?

- What is the maximum portfolio risk that I should accept at any given time?
- How should I increase my open positions when I experience a growth in my capital?
- How should I reduce my open positions when I experience a drawdown in my capital?

To answer these questions, we need to look at a number of variables. These can be split into two main groups:

- One group is subjective and includes an assessment of whether our risk profile is conservative or aggressive.
- The other group is objective and includes factors such as the volatility of the market, the tick value of the instrument, our average dollar win, our WinRate, our average dollar loss, and our LossRate.

Fixed Fractional Trading

Currently, two money management theories are in vogue. One is Fixed Fractional trading, an idea that has been around since time immemorial. Traders risk a percentage of their capital on each trade. This means that if we begin with US$100,000, and we suffer a loss of 2%, our next trade has a capital base of US$98,000. If our next trade again loses 2%, our next trade has a capital base of US$96,040.

There are two disadvantages to this approach:

1. If we suffer a series of losses, we will require a greater percentage increase on each successive trade to recoup our capital.
2. If we enjoy a series of profitable trades, we will begin risking more and more dollars as the winning streak continues.

LOSS				PROFIT		
Capital	Loss	% to Breakeven		Capital	% Gain/Loss	$Gain/Loss
$10,000.00	20.00%	125.00%		$10,000.00	20.00%	$12,000.00
$8,000.00	10.00%	142.86%		$12,000.00	10.00%	$13,200.00
$7,200.00	10.00%	166.67%		$13,200.00	10.00%	$14,520.00
$6,480.00	10.00%	200.00%		$14,520.00	10.00%	$15,972.00
				$15,972.00	-50.00%	$7,986.00

FIGURE 6.1 The impact of profit and loss with Fixed Fractional trading

Figure 6.1 shows what happens when we use Fixed Fractional money management after a series of losses, as indicated in loss column. After a 50% loss, we need to double our existing capital just to break even.

The profit column shows what happens under Fixed Fractional money management after a string of profits. After a series of winning trades, we suffer a loss of 50% but instead of returning to our original stake, we find we face a loss of 20.14%.

Fixed Ratio

The other method is called Fixed Ratio, the brainchild of Ryan Jones. In this approach, we maintain a fixed ratio to increase by one contract. He calls this ratio the delta.

The formula for increase is:

Previous Required Equity + (Number of Contracts × Delta)

= Next Level

Let's look at an example taken from Jones' book *Trading Game* (John Wiley & Sons, 1999), page 84:

- Delta: US$5,000
- Starting capital and first required level: US$10,000
- Starting number of contracts: 1

1. US$10,000 + (1 + US$5,000) = US$15,000 to increase to 2 contracts.

At US$15,000 to raise to 3 contracts:

2. US$15,000 + (2 × US$5,000) = US$25,000

At US$25,000 to raise to 4 contracts:

3. US$25,0000 + (3 × US$5,000) = US$40,000

To reduce the number of contracts, he suggests the option of exiting the position at a faster rate than the rate of increase. The formula for the rate of decrease:

(CL − (CL − PL) × X%) = Next level of decrease

Where:

CL	=	Current Level
PL	=	Previous Level
X%	=	Variable percentage

Let's assume that we had a PL of US$90,000, and made a profit of US$10,000 so that our CL = US$100,000. Let's further assume our delta is US$5,000 and we'll decrease at twice the rate of increase. The rate of decrease for our CL would be:

US$100,000 − ((US$100,000 − US$90,000) × 50%) = US$95,000

Jones says that there are disadvantages to this faster rate of decrease and I agree.

> Like Fixed Fractional trading, the faster you decrease, your ability to recoup the losses decreases proportionally. But as the drawdown continues, the percentage lost through faster rate of decrease will become significantly smaller than the percentage lost through.
>
> (*Trading Game*, p. 99).

However, there is a flaw in the Fixed Ratio method. Let me illustrate it:

Let's suppose that an instrument 'X' has an average true range of US$2,000 a day; and an instrument 'Y' has an average true range of US$400 a day. Which instrument do you think would find it easier to achieve a profit of US$1,200: instrument 'X' or instrument 'Y'?

That's the problem with Fixed Ratio trading. Since it deals only in dollar values, it assumes that all dollar values are the same. But that isn't true in this context. I favor considering the volatility of the instrument to normalize the formula so that we can apply it to a range of instruments.

My Approach

To understand how I came to this formula, we need to go back to a bright sunny Saturday at the Rosehill Race Course where I was introduced to the interesting world of professional handicapping. In the course of my education, I came across the works of Don Scott, the doyen of Australian punting. In his book, *Weights Right*, Scott says that if a selection had a 30% chance of winning, then that probability remains the same irrespective of the capital you have for punting after the results of your last bet.

What Scott said about punting applies to trading. If I had a US$98,000 account and I assess the probability of success for the next trade to be 60%, then my position size should be the same, whether or not my last trade was a win. In other words, if I started with US$100,000, and 60% probability called for 10 contracts, then, whether as a result of previous trade my account stood at US$96,000 or US$104,000, I should still risk 10 contracts.

That is the starting point. But we may have a problem if we continue with that logic. If my account drops to US$50,000, or increases to US$250,000, my position size would remain at 10 contracts. Clearly this does not balance optimizing profitability with minimizing risk of ruin.

To overcome this disadvantage, I decided that I would combine some of the ideas of Fixed Fractional trading with some of the ideas of Fixed Ratio trading.

First, I decided that I would set a threshold, and I also decided not to add gains to my trading until I reached that threshold. The calculation for that threshold has changed over the years. Currently, I am employing an idea derived from T. Chande's *Beyond Technical Analysis*.

He suggests that we can determine the maximum drawdown by the formula:

3 × The Standard Deviation of Monthly Losses

In conjunction with this formula, I use the formula for estimating the maximum possible consecutive loss for any period. That formula is:

M + ((SqRtM) × 3)

Where M = the average consecutive loss to date.

By combining the two formulas, I increase the position size each time my capital rises 15%.

To get around the problem associated with Fixed Ratio theory, I use increase or decrease of the entry price rather than just dollar values. My calculations now include the results, as percentage increases, for the *entire* trade and also the percentage *increase per contract*. For example, let's say I buy 10 contracts of E-minis at 1,500 and exit at 1,520. My percentage profit for the trade would be:

$$((1{,}520 - 1{,}500)*10)/1{,}500 = 13\%$$

On a per contract basis, my percentage profit for the trade would be:

$$(1{,}520 - 1{,}500)/1{,}500 = 1.3\%$$

The next step in my Effective Money Management method comes from Peter Steidlmayer. In his Market Profile courses, Steidlmayer suggested that position sizing should vary depending upon the probability of success. I distinguish three levels of risk:

- Above normal opportunity: I double my normal size.
- Normal opportunity: I apply normal size.
- Below normal opportunity, I halve normal size.

The fourth step is the Expectancy Return, which was introduced earlier in the chapter:

(Average % [Dollar] Win × WinRate)

− (Average % [Dollar] Loss × LossRate) = Long-term Success

The formula must produce a number greater than one, over a large sample size, for a trader to be successful. I found something else to be true: a trader has much more control over entries and exits than he does over his WinRate.

Figure 6.2 shows some of the statistics I keep. My financial year runs from September 1 to August 31. I have shown the dollar values rather than percentage increases because most readers will relate better to the dollar values.

Note the difference between the annual $ Profit and $ Loss; the $ Profit exceeds the $ Loss by about 1.8:1. The annual Expectancy Ratio also happens to be 1.8:1. This is the lower end of my historical boundaries; the upper end is 2.3:1. June is particularly instructive. It was the month I made most money but suffered the worst overall result because I did not control my losses. In June, I lost nearly twice as much as I lost in any other month.

Month	# Trades	Wins	Losses	$ Profit	$ Loss	Monthly Expect Ratio	US$ Monthly Result	Monthly Expectancy $	Total Wins	Total Loss
									167	172
2006									All Monthly Result	
Sept	10	7	-3	$24,915.00	($2,662.50)	9.36	$22,252.50	$16,641.75	$25,286.93	2.76%
Oct	26	12	-14	$103,937.50	($34,337.50)	2.59	$69,600.00	$29,481.73	$79,090.91	8.64%
Nov	3	2	-1	$3,025.00	($125.00)	24.20	$2,900.00	$1,975.00	$3,295.45	0.36%
Dec	23	13	-10	$28,815.00	($42,005.00)	0.89	($13,190.00)	($1,976.30)	($14,980.64)	(1.64%)
2007										0.00%
Jan	36	18	-18	$61,700.00	($51,146.20)	1.21	$10,553.80	$5,276.90	$11,992.95	1.31%
Feb	44	20	-24	$94,334.70	($38,263.60)	2.05	$56,071.10	$22,008.35	$63,717.16	6.96%
Mar	34	17	-17	$130,027.50	($70,125.00)	1.85	$59,902.50	$29,951.25	$68,071.02	7.43%
Apr	47	24	-23	$63,745.00	($50,745.00)	1.31	$13,000.00	$7,717.98	$14,772.73	1.61%
May	26	16	-10	$62,000.00	($36,625.00)	2.71	$25,375.00	$24,067.31	$28,835.23	3.15%
Jun	44	15	-29	$182,950.00	($132,957.50)	0.71	$49,992.50	($25,261.76)	$56,809.66	6.20%
Jul	46	23	-23	$141,982.50	($42,915.00)	3.31	$99,067.50	$49,533.75	$112,576.70	12.29%
Aug									$0.00	0%
Sep									$0.00	0%
				$897,432.20	($501,907.30)	1.8	$5,374	($2,918)		

FIGURE 6.2 Some statistics from my trading

I draw your attention to theses figures because the only factors in a trade that are totally within our control are our entries and exits. Years ago, I read a series of articles on the Internet written by the "Phantom of the Pits." The author suggested that most traders enter into a trade and exit only if the market proves them wrong. He believed a more productive approach would be to ask the market to prove a trade right. If it did not, he said, you should exit the trade immediately.

I thought that dictum suited my style of trading. Hence, whenever I enter a trade, I know the conditions under which I will continue to hold a position and the maximum time that I am prepared to wait for the conditions to appear. Once that time expires, I exit the trade. How long I am prepared to wait is instrument and setup specific, a concept I examined in Chapter 5.

Money Management Approach Summary

Let's bring together the various strands of my money management tenets so far.

Using the formulas, I know that the maximum drawdown should not exceed 24% (I allow for a maximum drawdown of 30%) and a maximum consecutive loss of 10% (I allow for 15%). Based on my subjective risk profile and these formulas:

- My stop for a normal size position is 2% of capital.
- I allow for a maximum portfolio risk of 10%.
- I accept that four consecutive losses are normal; beyond that I take a break from trading.
- My threshold is 15%, so I don't add profits to my capital base until I have increased my previous capital by 15%. I reduce my normal position size as soon as I suffer a drawdown of 7.5%. I use percentage increase and decrease of entry prices as ancillary tools.

- I use time and structural conditions exits to increase the difference between profits and losses.

Final Considerations

There are two more matters to consider before I move on to Winning Psychology. So far, I have considered my subjective risk profile, and my personal trading profile, including my WinRate and average dollar win. I still have to consider market data, including volatility, before I determine my position size in any given trade. The formula I use to define their basic contract size is complicated, but a reasonable approximation is the Turtle approach:

% Capital at Risk/US$ Value of ATR of Instrument

For example if the E-mini has an ATR of 10 points, the number of contracts I would enter on a capital base of US$100,000 would be:

$$2\% \times 100{,}000/500\ (10 \times \text{US\$50}) = 2{,}000/500 = 4$$

With this calculation, I then assess the trade subjectively and determine whether the trade warrants an increase or decrease of size. If it does, I adjust the size of the stop and the "Turtle size" accordingly. I arrive at the final size by a subjective assessment, taking into consideration the stop size and Turtle size.

Let's look at an example.

On March 6, I bought the ADUS. If my capital base was US$100,000, I'd have taken a position size of 20,000 ADUS. Here are my calculations.

- My normal size stop is US$2,000 (2% × 100,000).
- My risk was 90 points per 10k size, with entry around 0.7757 and a stop at 0.7667. This meant I could take a 20,000 position size.
- The ADUS volatility was about 70 points per day. Thus the Turtle position size was: 2,000/700 = 2 to 3 contracts.
- I now had to consider whether I would treat this trade as one that warranted a normal or above normal position size.

Here is my rationale:

- The pluses were the high probability that the 18-day trend would continue, the likely target around 0.8840 (this meant I'd be exiting final thirds around 0.8800 to 0.8820), and the Negative Development setup.
- The minuses were that the core profit ratio showed a mere 2.8:1. I like to see a higher ratio because I usually discount the pre-trade ratio by as much as 33%. Based on these factors, I'd have taken 6 contracts.

Figure 6.3 shows the trade entry details.

FIGURE 6.3 ADUS Daily
Source: Graphics used with permission from *Market Analyst*.

The final question we have to address is whether there are any objective inputs to help us determine the percentage of capital to risk?

The 2% rule is a good rule of thumb. A better approach, after 30 winning trades, is to calculate the Maximum Adverse Excursion. John Sweeney introduced this idea in *Maximum Adverse Excursion* (John Wiley & Sons, 1997).

The idea is simple. Work out for winning trades how much the market goes against you before it moves in your direction. Then use that information to work out what your risk is, as a percent of capital, for a normal trade. Here are the steps I take:

1. Work out the maximum dollar value of the points, if the market moves against you. Let's say in one winning trade, the market first moved 3 points against you, that is US$50 × 3 = US$150.
2. If your base capital is US$20,000, on a one contract basis, this means a move of US$150/20,000 = 0.75% per contract.
3. Do this for 30 trades.
4. Then work out the mean and standard deviation.
5. I use mean +2 standard deviations as my benchmark. In other words, I work out, on a percentage basis, how much the market will move against me and still end up in my favor.

6. When using this approach in your trading, make sure you remember that the calculations are on a one-contract basis and allow for that if you are using multiple contracts. For example, let's say that your mean is 1% with a standard deviation of 0.25. On a one-contract basis, you would be risking 1.5% per contract.
7. The final step is to look at your risk profile and come up with a percentage loss for a normal trade.

There you have it: a short summary of my money management ideas. Let's now turn to the success factor that is 60% of the equation: Winning Psychology.

WINNING PSYCHOLOGY

Introduction

Psychology makes up 60% of the success equation. Winning Psychology encompasses a wide range of issues from behavioral finance to the qualities of successful and unsuccessful traders, from the management of our automatic emotional responses (what is sometimes referred to as our "rat brain") to the decision-making process, and from understanding and overcoming mental obstacles to the acquisition of trading skills.

In this chapter, I shall provide an overview of what I consider the essentials. We'll start with the philosophical context and then proceed to the decision-making process. From there, we'll examine some techniques to help us work through our emotions.

Philosophical Context

In any endeavor such as trading, the philosophical context is crucial. One of the greatest influences in my life has been the works of Ayn Rand, a novelist-philosopher who has not been given the recognition she deserves.

Rand wrote that man's operating context is "objective reality" and in dealing with that objective reality we need reason. Recent research, such as the works of Antonio Damasio, has shown that within the decision-making process, reason without emotion is not only impossible, it isn't even desirable. In short, the research shows that a robust decision-making process requires both rational and emotional input. I consider these discoveries to be extensions of Rand's ideas.

Rand also taught that one of the virtues needed for rationality was honesty. She defined it as the refusal to consciously fake reality in any shape or form. The key word here is "consciously." We may misinterpret reality and this is merely making a mistake. What we cannot do is to deliberately fake it.

A great example of this distortion can be seen by the behavior of someone I know well.

He and I began trading at about the same time but he deals with losses by not opening his brokerage statements. His rationalization: he will eventually make up the losses so the statements reflect only a temporary situation. The winning

statements lay strewn across his desk for all to see. It doesn't surprise me that he has not had a winning year for the past 30 years.

This virtue of honesty is a foundation for successful trading. Without that, we won't learn from our losses and mistakes. We will hide from our losses and exaggerate our profits.

To this philosophical foundation of honesty, we need to add certain skills. One of the skills is a robust decision-making process.

Decision-Making Process

Left Brain, Right Brain

Logical thinking is the province of the left side of the brain. The best advice I can give in this area is to adopt an idea of Rand's: *check your premise.* To ensure that I do this, my decision-making process involves an analysis of the three possible trends in any given situation: up, down, or sideways. I'll share an example of my process later in this chapter.

The other side of the decision-making process is the creative side, the right brain. In this process, I allow trading ideas to bubble forth from my experience. Here's an example:

I trade the 18-day time frame. My first higher time frame is 12 months; my second is 13 weeks. Since I start with a top-down approach, let's first look at the 12-month swing. The idea is to see if anything jumps out at me. Generally, I'm seeking an answer to the question: *What does the 12-month time frame have to say about the change or continuation of the 18-day trend?* Figure 6.4 shows the 12-month AUD/USD.

FIGURE 6.4 AUD/USD 12-Month Swing
Source: Graphics used with permission from *Market Analyst*.

The point I would note is that there is a potential sideways trend forming. A monthly close with bearish conviction below 0.8366 would be the first warning that the sideways trend has formed; two consecutive closes with bearish conviction would be confirmation. If a sideways trend does form, the target is the Primary Buy Zone at 0.5288 to 0.4775.

On the other hand, if the market closes near or above 0.8366, then we'll see a strong rejection extreme between the open or close (whichever is lower) and the low. This would be bullish for the 18-day AUD/USD trend.

In essence, I am brainstorming the charts and noting bullish, bearish, and neutral patterns.

I repeat the process for the 13-week and 18-day time frames. If I see a possible forecasting pattern forming on the 5-day swing, then I shift down to the 5-day swing for a closer examination.

When this process is complete, I have a list of observations and questions that need to be answered by the left-brain analysis. This takes the form of seeking answers to the questions, such as:

1. *What is the 18-day trend and is it likely to continue or change?* To answer this question, I need to consider the trends and reference support and resistance points of the 12-month and 13-week time frames. The answer to the question provides me with a strategy. It tells me whether I should be seeking to trade, and, if so, whether I should be a buyer or seller. Armed with this strategy, I now look for low risk entry.
2. *At what prices do I find support for buys or resistance for sells?* Once I have located the zones of support or resistance, I then find out if the market is at or near the zones. If so, I move to the next question.
3. *Do I have a Negative Development or Contraction setup?* If I do, I seek answers to the next series of questions.
4. *What entry pattern do I need to see to initiate the trade and where will I place my initial stop? Where will I exit my core profit contract? What is my risk/reward? Does the risk/reward suggest this is a trade worth taking? What is my target for the third contract? How long do I expect to be in the trade for the core profit contract? How long do I expect to be in the trade for the third contract?*
5. Other questions I ask include: *If I take the trade today, what do I have to see to remain in the trade? What is the maximum time I am prepared to wait for the market to move 1.5 × ATR from entry? What do I need to see immediately to exit the trade?*

The answers to these questions provide a roadmap that guides my trading after entry. Figure 6.5 is the checklist that I use to provide a measure of objectivity. If I am bullish for the market, then the total ratings should support that conclusion.

DATE			
Element	Unit	Indicator	Weighting Total
PRICE	Structure	Ray Wave	
	Targets	First Shock	
		Fibos	
		Hurst	
	Momentum	Ray's Clock	
VOLUME	Total	Total	
	Buy/Sell	Market Delta	
	B/S Levels	Market Profile	
TIME	Gann	GannG & Harmonic	
	Cycle	Fortucast	
	Seasonal	Erlanger	
SENTIMENT	Consensus	WhisperN & SentimentT	
	COT	Upperman	
	News	Mags and Papers	
Weighting	1 to 3 where 3 most bullish and -3 most bearish		

FIGURE 6.5 Weighting Checklist

When I get to the bottom of the checklist, if the conclusion does not reflect my analysis, then I redo the analysis, checking my premises. My aim is to secure a trade decision that reflects reality to the best of my ability. The process allows me to say that "this trade is likely to be profitable," and then I'll be able to define the price action that ought to follow, AFTER I enter.

If I have decided to take a trade, there is a final step to my analysis process: I ask the question: "*How do I feel about taking this trade?*" If there is no conflict, and I'm comfortable with a trade, the analysis process stops there. But if I sense discomfort, then I probe for the causes of that discomfort. The causes could reside within the charts themselves or sometimes I find the reasons among events in my life at the time. What is important is to identify whether the discomfort is a signal that the unconscious mind has seen something missed by the cortex.

The most dramatic example, in my trading, occurred some years ago. At the time, Equity Systems, a software developer for Reuters, employed me as a technical advisor. The company provided me with premises to trade and real-time information systems. One day, just before the lunch break, I bought 10-year bonds. A friend was with me took the same trade. No sooner did I get into the trade than I felt uneasy. My friend said I was like a "cat on a hot tin roof." In fact, I felt so uneasy, that I attempted to exit the trade shortly after entry but the market had closed for lunch. When the market resumed at 2 p.m., I picked up the phone and sold at market.

Of course, as soon as I sold, the market went up. My friend asked me why I had dumped the long position and how I felt now that the market looked so strong. *I told him: "I don't know, I'm just glad I'm out of this trade."*

About 30 minutes later, the market tanked. To add insult to injury, the move down was so strong that my friend suffered a two-point slippage on his stop, a rare event in those days.

That night I went over my charts but I could not identify what it was that had induced me to exit the position.

This rigorous process of examination requires as much honesty as we can muster so that we can distinguish between intuition and "into wishing." But, if done correctly, it plays an invaluable part in a discretionary trader's toolbox.

Another right-brain tool that I use is a variation of Scenario Planning or Scenario Thinking, which is a strategic planning tool that some organizations use to make flexible long-term plans.

Scenario Planning

Scenario Planning involves the storyteller in all of us. In trading, once we know what the market has done, we create stories to describe a cause and effect structure. In scenario planning, we effectively "future pace." We act as if the future has happened and we have the advantage of looking over our shoulder to define the benchmarks that defined the experience. Because the market is uncertain, we need multiple perspectives, each one with its own internal logic and consistency.

I have three steps in my Scenario Planning that I have adapted from Peter Schwartz's *The Art of the Longview: Planning for the Future in an Uncertain World.*

1. Identify the assumptions for defining the trend as up, down, or sideways.
2. Identify the benchmarks for each of the three trends.
3. Create a brief story around each of the three trends, including an identification of the benchmarks that would suggest the scenarios are deviating from the storyline.

I'm not suggesting that this is the only way to incorporate right- and left-brain analysis. This just happens to be the way that I do it and it may not suit you. I am suggesting that within your decision-making system you should integrate both logical and creative thinking.

Behavioral Finance

In all of these processes we need to be aware of the biases identified by the science of behavioral finance. This is not the place for an in-depth explanation of the science. There are many good books on the subject including *Inside the Investor's Brain* by R. L. Peterson. What I'd like to do here is to review the biases that most affected my students.

Anchoring

This is when a trader decides to enter and/or exit at a price rather than just entering or exiting according to the dictates of the prevailing market conditions. You would think someone like my wife, Christine, who has seen the worst and best of my trades, might know better, but this incident proved otherwise.

Many years after my trading showed consistent profitability, Chrisy told me she wanted to try her hand at trading. We agreed to a capital base of A$25,000 and I agreed that she would be the sole decision-maker. A few days later, our friend, Howard Elliott, recommended she buy the Hong Kong PCCW shares for a run to HK$25 per share. He expected the run would take a week to ten days.

Chrisy bought the shares at HK$20 and a day or so later PCCW went to HK$25! Wow, a 20% gain in one day! Did my baby exit her position? Of course not. She thought this would be the granddaddy of all trades and would make her a millionaire in one trade. After hitting HK$25, PCCW started to slide and it finally returned to her entry level. At this point I said:

> *"Aren't you going to exit?"*
>
> *"Sure, just as soon as it returns to HK$25."* (She had now Anchored at HK$25.)
>
> *"What if it doesn't get back there?"* I asked
>
> *"I'll exit if it breaks HK$20."*
>
> The next day, the market gapped down, so I said:
>
> *"Aren't you going to exit?"*
>
> *"When it gets to HK$20."* (She had now Anchored at HK$20).

PCCW slipped to around HK$5 and, all the while, Chrisy anchored at a price higher than the stock ever attained in its bear market rallies.

Chrisy exhibited the classic symptoms of Anchoring, first at the target exit, and then at her entry. To avoid this bias, we need to set an exit based on our assessment of market conditions rather than some set price.

Loss Aversion

The next most common bias I have encountered is Loss Aversion.

In the section on Money Management, I showed that the key to success was for our dollar loss to be a clear second to our dollar win; or as Wall Street puts it: *"Let your winners run and cut your losses."* But we are hard-wired to avoid pain and most traders feel pain as they realize losses. The effect of Loss Aversion can be catastrophic to our bottom line. The problem lies in the uncertainty of the markets. We cannot tell what the future will bring. When the market first goes against us, we tend to believe that the market will reverse and make up the losses for us. Indeed, sometimes it does just that. Nick Leeson, infamous as a trader at Barings, initially learnt that all he had to do was to add to a losing position and all would be well.

However, there are times that the market does not rescue a losing position. At those times, one of two things happen:

1. Fear pervades our thoughts and feelings so that the pain of realizing the loss is swamped by the fear of further loss. At this point, we impulsively exit the position—usually just before the market does resume a move in our favor.
2. If we are trading a leveraged market, we run of out money and are unable to meet a margin call. (Nick Leeson eventually lost so much that Barings, a proud institution with 200 years in banking, was sold for a just £1.)

The best way to overcome Loss Aversion is to plan your trades. You need to know what has to happen to stay in a trade; what has to happen to exit a trade; and above all, place a stop loss order at the price beyond which you are not prepared to bear any more losses.

Gambler's Fallacy

The third bias is the Gambler's Fallacy. In this bias we believe that just because we have a series of consecutive losses or wins, we are due for our luck to change, and we make this decision without reference to market conditions. The Martingale Money Management Approach is based on this idea. There is little rational basis for such an approach and its pursuit will lead to ruin.

The way to avoid this bias is to treat each trade as independent and assess each one on its merits.

So far we have been dealing with mainly the cognitive side of the problem. But it's the next section that I believe contains the trader's salvation. It's the area of managing and integrating our emotions during times of stress.

Managing Stress

Not all stress is disempowering. Mihaly Csikszentmihalyi in his book, *Flow* (Rider & Co., 2002), found that some level of stress is conducive to optimum

performance—we need to feel that the challenge is just beyond our skill level so that we rise to meet it. The problem arises when our fight or flight responses overpower our emotions. When that occurs, two feelings arise: threat and helplessness.

When I become overwhelmed by stress, I make unplanned, seat-of-the-pants trades. As a result, my exit conditions are not predefined and they are more than likely to result in losses that are outside my money management guidelines. As a result, I have taken certain steps to ensure that my stress levels remain manageable on most occasions.

Firstly, we need to catch the fight or flight emotion before it overwhelms us, and, secondly, we need a set of tools that dampen the emotional overflow and allow us to accept the prevailing conditions. This helps us operate normally again.

The first requirement is one of self-awareness. We need to be aware of our unique bodily responses that signal that stress levels have reached a point where robust decision-making is difficult. In my case, because I trade on an intraday basis, I find that I am most prone to stress attacks when entering trades. I find it relatively easy to be relaxed when not watching the price action during market hours.

Some short-term tools that I use:

- A biofeedback machine that warns me when my stress levels are excessive.
- I get up, walk away from my back tree of computers and perform some stretching exercises for 60 seconds or so. This small physical break does wonders. It allows me to compose myself and to mentally prepare myself to walk into my trading room and re-analyze the market.
- I also use a longer-term tool that I call progressive meditation and I have found this extremely effective.

Most of you are probably familiar with meditation. Its benefits have been extensively documented, as have the various traditional meditation techniques. In progressive meditation you begin with a traditional technique and add to it what NLP calls anchoring. This means that we add a physical gesture to the meditative technique as we feel ourselves slipping into the meditative state. It helps if we use music to accompany our practice sessions. After a time, we will find that the use of the anchor and the music will automatically shift us into the meditative state.

Once we achieve this, we start to reduce the time it takes to produce the alpha state associated with meditation. In my case, the accelerated process doesn't produce a state as deep as normal meditation. But it has certainly allowed me to slip quickly into alpha state and take control of what Dr. Janice Dorn calls my "rat brain."

Progressive meditation taught me how to remain unruffled and centered during the hurly-burly of real-time trading. More than any other tool I use, it teaches me that AWARENESS is everything.

Do the ideas and tools work in the real-world? This was the question I asked myself when a student and I recently engaged in an experiment to see whether my methods would work in a short-term situation. We participated in the Daniels Trading *FX Futures Million Dollar Trading Competition* that began in June 2007.

It's important that you understand that trading in a competition is very different than trading for long-term profit and long-term consistency. For this reason, I ran the strategy and my student, Anna Wang, executed it: I determined the trend and position size, Anna identified the zone, entry, and exit strategies.

The day before the last day of trading, we were running in first place with 74.40—see Figure 6.6

Million Dollar Trading Competition - Updated as of July 27th

James A. Kaminecki <jkaminecki@danielstrading.com> 31 July 2007 21:39
To: Undisclosed Recipients <jkaminecki@danielstrading.com>

Million Dollar Trading Competition

Results Update as of July 30th, 2007

Below, the participants are listed by the last two digits of their trading account number along with current results.

Standing	Trader	ROR as of July 27, 2007
1	55	74.40%
2	425	70.49
3	38	11.3%

Best regards,

James A. Kaminecki
100 South Wacker Drive, Suite 1225
Chicago, IL 60606

FIGURE 6.6 Daniels Interim Trading Result

The last day of the competition produced a small range day, which did not suit any long-term positions. I looked for a day-trade that might assist but I could not see anything to help our position. We ended the competition with 75.29% return on capital—see Figure 6.7. The winner was able to overhaul us on the last day.

The interesting thing is that we achieved the 75% result with a maximum initial exposure of 15%. The broker in charge of the competition told my partner: "No matter who finished with a higher percentage on the date of July 31st, you

FIGURE 6.7 Daniels Final Trading Result
Source: Graphics used with permission from *Daniels Trading*.

and Ray set the standard for everyone to follow." (James Kaminecki in an email to Anna Wang on Aug. 4, 2007)

Still, it's important to realize that we were lucky. To understand why, I need to provide a little background: I had chosen the ADUS as the instrument to trade for the competition. This is because its volatility suited our capital base and it offered the prospect of a strong directional move in the two months of the competition. Our capital base was large enough to provide adequate protection against risk of ruin.

But in addition to sticking to our internal exposure limit we faced another disadvantage in the competition. When trading against smaller bases—we needed to generate greater profit to bring about the same return on investment. Technical conditions showed the ADUS was preparing for a strong run. It was basing around 0.8400 and I believed that if the ADUS could break out, either up or down, the markets would go for a run. The upside target was 0.8800, a possible 400 point profit, and the downside target was 0.7990, about a 400 point profit. For reasons I won't go into here, I favored the upside.

Why were we lucky?

1. The ADUS actually did what the probabilities said it would do. On a trade-by-trade basis, the fact that the probabilities favor a trade does not mean that the trade will make money, it is only on a long-term, large sample size basis that probabilities provide the edge. Hence, a single result or results, over a short period, have little prognosis value.
2. The ADUS, having broken up, provided a great return by moving directionally. It did not have to move from 0.8400 to 0.8800 in a month. True, I did believe the odds favored the move but again this did not mean it would happen.

The competition showed that the tools in this book, especially the tools I use to remain stress free and focused, produce results—not only for me but also for anyone who applies it. And this brings me to an approach I use to protect against reposition the "rat brain" while trading.

On a cognitive level, this calls for Acceptance of the outcome of a trade. By Acceptance I mean the ability to be aware of an emotion without "buying into" its content; some may call this "mindfulness."

For example, imagine you have just entered a trade and the very next bar is a big range bar against your position. You might begin to think:

> "My God here I go again! Can't I do anything right! What will my wife say if I take yet another losing trade?"
>
> "Maybe I should move my stop? No I can't do that—the last time it cost me my bank! But what about the other day when...
>
> "...I got stopped out only to have it go my way? This is just too hard!"

Contrast that with this scenario.

Imagine you have just entered a trade and the very next bar is a big range bar against your position. Instead of panic, you think:

> "The market is approaching my stop. I feel uncomfortable with the price action and I can live with the discomfort."

In the first scenario, the trader may think he has accepted the outcome but in fact he hasn't at the emotional level. In the second scenario, the trader has accepted the outcome at all levels.

This idea of Acceptance applies not only to losses but to profits as well. The trader who fully "accepts" an outcome realizes that, on an individual trade basis, a positive outcome on one trade does not translate into a future of unlimited profits.

At its core, Acceptance means that a trader realizes that trading is based on probabilities and as such every trade is unique. In other words, the past does not equal the future.

To acquire true Acceptance, certain personal attributes are essential:

- Awareness—the ability to step outside ourselves and observe. The more effectively we can do this, the easier it is to reach Acceptance.
- Honesty—the ability to perceive reality in spite of our filters.
- Courage—the willingness to bear the pain brought about by our awareness and honesty.
- Commitment—the willingness to do whatever is necessary to achieve our goals.

In the words of Chin-Ning Chu, author of *Thick Face, Black Heart*:

> Even though most people think they are trying to succeed, they are simply going through the motions. The last thing in the world they want is to get off the familiar treadmill and actually get somewhere.

We cannot succeed in our journey to Acceptance unless we acquire these attributes. To the extent that we have them is the extent to which we will experience fulfillment.

Ultimately to succeed, as traders, we also need to adopt two apparently contradictory beliefs:

- The market is uncertain and unpredictable and the market is relatively certain and predictable.
- The resolution of this apparent conflict is found in the time frames that we hold the beliefs.

At the trade-by-trade level, what Mark Douglas, a well-known trading coach, calls the micro level, we should believe that the market is uncertain and because the market can and probably will do anything, we should protect our capital in executing our trading plan. In other words, we must always have an exit strategy.

At the level of a large sample size, or the macro level, we should hold the second belief, that markets are predictable, and to the extent that, our trading plan has an Edge, the market will be predictable and certain.

In short, we accept that with trading we are dealing with probabilities and not certainties.

It is imperative that we hold these beliefs not only at an intellectual level but also at every level of our being—especially the emotional level.

As a trading coach I have seen, time and again, lip service Acceptance to the idea of probability; but when it comes to actually trading, traders behave as if each and every trade must be a winner. They have a need for certainty.

How else can we explain the popularity of services advertising 90% hit rates? If the ads were not drawing an adequate response, they would disappear.

As Mark Douglas points out, probability thinking leads to a host of other states and beliefs.

1. Because we know that we will succeed in the long run, and, because we know we will protect ourselves no matter what the market does, we acquire the state of "self trust" and the state of being "carefree." In turn these states allow us to remain focused.
2. Being focused, confident, and carefree helps us when we are experiencing the inevitable prolonged drawdown.
3. We can do this because at the micro level we know that the market is random. We will not allow euphoria to set in and lead us to reckless trades. Each trade will only be one in a series of probabilities.
4. We will view market information not as a source of pleasure or pain but merely as data providing us with opportunities. This is not to say trading should be tedious; indeed not only should it be fun, but for most traders it MUST be. However, the fun comes from the consistent execution of the rules appropriate to our stage of evolution and not from trade-by-trade results.

The main enemy to Acceptance is Fear. The universal Fears are the Fear of being abandoned and the Fear of losing control.

If we reflect for a moment, we'll see how the Fear of being abandoned arises from our childhood.

As young children, we are totally dependent on our parents. Very quickly we come to realize that if they ever abandon us, we shall be unable to care for ourselves. Most of us fail to confront this Fear as we grow into adulthood. As a result we automatically deal with it by attempting to control our environment—the people, conditions, and events that surround us.

This tendency to control may or may not be appropriate in other areas of life but as a strategy for trading the markets it is a bust. Most of us are incapable of influencing the market even for the shortest moment, let alone control it.

Mark Douglas lists four Fears that are an outgrowth of the two universal Fears and may be more familiar to the trader:

1. Fear of loss
2. Fear of being wrong
3. Fear of missing out
4. Fear of leaving money on the table

I first gained an insight into the effects of Fear some years ago. At that time, I was trading through Jackson Futures. The company provided a trading room and I met a quiet chap there. He came in a few minutes after the US bond market

opened and left just after the close. Given that trading opened at 12:30 a.m. Australian time and closed at 5:00 a.m., this was no mean effort.

One morning I noticed he looked very distressed and I struck up a conversation with him. He told me he had bet the farm shorting a strong bull market. As his red-rimmed eyes stared off in the distance he said:

> I don't know why I just didn't cut the position earlier; anyone would have seen the strength—why didn't I?

I never saw him again.

That is the effect of Fear—it drives out knowledge; it leads to myopia; it immobilizes us and leads to paralysis.

The mirror image of Fear is Euphoria, the feeling that we can do no wrong. As much as Fear, Euphoria will ultimately lead to trading failure. Since trading is a game of probabilities, we will experience times when we can do no wrong. But these times will come to an end. The trader caught in the euphoric trance will not recognize this, and, taking one risk too many, he will eventually get caught in a heavy loss. If he is lucky, the loss will not be catastrophic.

Fear and Euphoria can catch not only newbies but also the most experienced and successful trader. Two other factors impact on our emotions:

- Our expectations—rather than accept market information in its pure form, we impose our expectations. In turn these expectations impact our Fear or Euphoria.
- Our own psychosis—Each of us grows into adulthood with our psychosis—what the psychologist, Stephen Wolinsky, calls "trances." Thus, many times, our responses to market information are not a response to present information but to past events. In other words, we are not trading in the NOW or with PRESENT TENSE INFORMATION.

To achieve Acceptance, we need to manage Fear and Euphoria. Let's consider some other tools that I have found useful.

In my case, the decisive tool was learning strategies to be aware of, acknowledge, and manage the twin emotions of Fear and Euphoria. This meant starting with small pains and slowly becoming comfortable with my feelings.

When I first started trading successfully, I used discipline as my main weapon. But when I started fund management in 1991, I found it inadequate. Dr. George Lianos helped me discover the way of managing, not eliminating, my emotions. George taught me that a step-by-step approach was the best way for me. Learning to manage small Fears, I slowly learnt to handle Fear and Euphoria in my trading.

I have developed a process based on the works of Stephen Wolinsky, who wrote *Tao of Chaos* and *Bramble*, and C. Andreas, the author of *Core Transformation*.

Ray's Emotional Process

The goal of this process is to allow us to be friends and lovers with our feelings. Most traders I have met deal with pain through denial and suppression. This is understandable because as humans we move away from pain; what I find strange is that the same traders have a strategy that prevents them from fully experiencing their joys. They do this because they attempt to hold on to the feelings of joy, and, in doing so, they become so concerned about losing out that they neglect to experience—really experience—their feelings of joy.

As I said, I find this strange. Finally, I have realized that traders do this because they are strangers to fully feeling their emotions. My process is designed to introduce you to, and eventually bond you to, your feelings.

The process is simple.

1. You first allow yourself solitude and fully experience the pain or pleasure. At some point the intensity will pass.
2. Give the emotion a location and shape. *Where do you feel the pain? Is it in the pit of your tummy? Is it in your throat? What shape is it? A hard fist? A boa constrictor?* Stay with the location and shape.
3. Then allow the conscious mind to ask a series of questions and then to listen, really listen, to the subconscious. You are seeking to establish rapport; if you have neglected your emotions for a long period, this will take time.

The questions are designed to draw out the subconscious. We want to understand what it is about the event that is causing the feeling.

There are a few assumptions made in this process.

The first is that our psyche is composed of parts. All behavior is the result of some part seeking a positive outcome—this is true whether or not the behavior is appropriate. By understanding the purpose of each part, we can negotiate with the part to substitute a more appropriate behavior for the outcome.

The second is that before we commence the negotiations we first must have deposited a credit of goodwill with our subconscious. The currency of the subconscious is our feelings. If we have neglected our emotions for years, we cannot expect our subconscious to trust us immediately; so the process will take time. I would schedule a "quiet time" of 20 minutes twice a week. In this way when the need arises, we shall have built a deposit of goodwill.

Below is an excerpt from my journal. I write the journal by hand because I am not only looking to keep a record but also want to enjoy the kinesthetic experience of writing.

The journal entry is copied verbatim from the record I made on September 19, 1996.

By way of background I should mention that I had not been trading well in 1996. In the first three months, I had hit a record 23% drawdown. By September, I was doing better and had brought that down to an 8% drawdown; nevertheless

I had not made any money for nine months! I had been watching the GBP/DEM since September 11 and I believed it was about to make a very strong move up. I also felt I would soon get a chance to take a position. But at this time I was very fearful. I sat down for some "Mountain Time," which is my name for the process.

Journal entry September 19, 1996

I sat down for 15 minutes. I felt my heart hammering—I forced myself to sit with it.

After 15 minutes: I was afraid and its shape was a solid rock in my stomach and a boa constrictor around my heart and throat.

CONSCIOUS: *Hi! How are you feeling?*

SUBSCONSCIOUS: *Very scared! I want to run and hide. Why do I have to trade again? I know I can trade—why do I have to keep proving it? It's just not fair—why don't you get a job so I don't have to trade?*

CONSCIOUS: *What I hear you saying is: you are very frightened because you have to trade. Is that right?*

SUBSCONSCIOUS: *Yes that's right.*

CONSCIOUS: *If you did not have to trade would you have all that is important to you, so you wouldn't have this fear?*

SUBSCONSCIOUS: *Yes! No! No, I would miss the trading. It is so much a part of my life.*

CONSCIOUS: *What needs to happen for you to feel safe?*

SUBSCONSCIOUS: *I want to be looked after—I don't want to feel threatened.*

CONSCIOUS: *What has to happen for you to feel safe?*

SUBSCONSCIOUS: *I want to be sure I won't lose money on this trade. I couldn't stand a 2% loss.*

CONSCIOUS: *You want a guaranteed winning trade?*

SUBSCONSCIOUS: (*Laughs*) *I'm being silly, aren't I?*

CONSCIOUS: *Do you feel silly?*

SUBSCONSCIOUS: *Yes, just a little—a guaranteed win? (Laughs again). But I do want to feel safe.*

CONSCIOUS: *What has to happen for you to feel safe?*

SUBSCONSCIOUS: *How about placing the stops now, even if the market is a long way away. Would you be willing to do that? I don't know if I'm in the frame of mind to handle "floating stops."*

CONSCIOUS: *Sure.*

A few comments would be appropriate.

1. Note that CONSCIOUS only asked questions. Sometimes it makes brief comments but overall it listens.
2. CONSCIOUS first asked how SUBSCONSCIOUS felt and only then did it probe for causes.
3. The questions asked were "what" questions not "why."
4. The process stopped when SUBCONSCIOUS identified what had to happen for it to feel safe.
5. The outcome was a negotiated settlement to place physical stops. I have no doubts that had I just ignored the fear, I would have sabotaged myself.
6. I have been doing this process for some time so CONSCIOUS had loads of "credit deposits" with SUBSCONSCIOUS; if not, I doubt that the process would have taken so short a period.
7. Once you have the internalized the process, it develops a life of its own.
8. When I made the journal entry, it was a written journal. Now I use Camtasia to record my trades and to make the entries for this process.

Other tools I have found useful are: Neuro Linguistic Programming (NLP) techniques, breath, and posture. NLP is useful for dealing with, understanding, and working through pain. It is a medium term technique. Learning to breathe, stand, or sit properly can be effective short-term tools to remain calm in periods of stress.

To succeed, a trader must have a vision about where he is heading and must internalize that Winning Psychology rests on a probability mind-set. Part of this mind-set is Acceptance of the trading outcome. This means managing Fear and Euphoria. To do this, we need to ACCEPT, with every fiber of our body, the belief that at the micro level the market is uncertain and unpredictable and at the macro level it is relatively certain and predictable.

In the next chapter, I will show how to draw together the various strands in order to take advantage of low-risk, high-profitability opportunities.

CHAPTER 7

Barros Swings in Action

INTRODUCTION

For me, this is the fun part of the book. The basics have been covered: we have learnt to identify the trend, and a change in trend, for a specific time frame; we have also had a look at some secondary tools. In this chapter, by analyzing the price action of a couple of instruments, we will see the Barros Swings in action. The market action is current at the time of writing.

The following process is derived from the theory of immersion. If you diligently apply the procedure, you will exponentially increase your learning curve.

For the purposes of the examples, we will assume that your trader's time frame is the 18-day. The method consists of:

- answering the questions in sequence;
- making a note of the answers; and
- reviewing your decisions weekly and monthly, to ensure that the lessons you have learnt become second nature.

Starting with the first higher time frame, in this case the 12-month swing, the first questions you need to ask are:

1. *What is the line direction?*
2. *Where are the 12-month support and resistance levels?*
3. *Is the line direction likely to continue or to change?*

Next, shift to the second lower time frame, in this case the 13-week swing, and ask:

1. *What is the trend?*
2. *What is the line direction?* Note that there is a difference between line direction and trend direction. A line direction is merely a swing direction in an ongoing trend.
3. *Is the trend and/or line direction likely to continue or to change?*
4. *Where are the 13-week support and resistance levels?*

Strictly speaking, the next time frame is the 18-day; we are looking either to trade in line with its trend or for a trade that involves a change in trend. As the 18-day line or trend approaches the 12-month and 13-week support or resistance levels, we want to see if it is likely to respect the zones or whether it will continue its line direction.

On most occasions, an 18-day line change will be signaled by a 5-day change in trend. So, we will examine the 5-day swing and see how it is reacting to the higher time-frame support or resistance areas.

For the 5-day line trend, ask:

1. *Do we have a change in trend pattern?*
2. *Does a comparison with the previous impulse swing indicate continuation or change?*

Once we have covered the 12-month, 13-week, and 5-day, we have created a background for analyzing the 18-day.

1. *What is the current 18-day trend?*
2. *Is the trend in its infancy or is it mature?* At this stage, we answer this question by using the breakout point as a reference point. If the market has just signaled a change in trend with a Whole Point Count (WPC) and Line Change Count (LCC), it is in its infancy.
3. *Is the trend likely to continue or to change?*
4. *Is the 18-day momentum indicating trend continuation or change?*
5. *Are any potential changes in trend patterns unfolding?*
6. *If the current line is moving against the 18-day trend, ask questions 2 to 5, as well as:*
7. *What are the 18-day support or resistance zones?*
8. *How is the 3-day reacting to them?* Here we are looking for clues that will tell us if the 5-day impulse move (18-day correction is the same as a 5-day impulse move) is coming to an end.
9. *Is the 3-day momentum indicating 5-day continuation, or change in the 5-day line direction?*
10. *Are we seeing climactic volume and range?* (By "climactic," I mean in the third standard deviation. This suggests that a change in trend is imminent as evidenced by a change in trend pattern.)

After we have gathered the information, we summarize it and use it to create a plan of action. This plan includes a description of price action that tells us revision is necessary.

Let's have a look at a few real-time examples. We'll start with the Dow Jones Industrial Averages (DJIA).

ANALYSIS: EXAMPLE 1

Twelve-Month Time Frame

Figure 7.1 is a 12-month swing chart.

FIGURE 7.1 Dow Jones Industrial, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

1. What is the line direction?

The line direction is up, as is the trend that commenced in 1982. So far, the market hasn't breached a 12-month swing low since this uptrend commenced. The last swing low occurred in October 1990.

2. Where are the 12-month support and resistance levels?

Support is found at the swing low at 7,181. To identify resistance, we need to dig beneath the surface to come up with a forecast.

3. Is the 12-month line direction likely to continue or to change?

The 12-month has been in an uptrend since October 1, 1990. In terms of percentage increase and time spent in an impulse mode, the uptrend is in the third standard deviation. I would expect the current swing low at 7,181 to be merely one low as a congestion market forms—that is, at some point I expect to see a re-test. But first the market will tackle the Primary Sell Zone of 11,908 and 7,181. If this is correct, we can expect the market to retrace at least 78.6% from the all-time high at 11,908 to the current reaction low at 7,181—the 78.6% level is found at 10,896.

Figure 7.2 shows the maximum limit of the congestion range and the 78.6% retracement level, the minimum retracement the market needs in order to qualify as congestion.

FIGURE 7.2 Dow Jones Industrial, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

Thirteen-Week Time Frame

1. What is the 13-week trend?

Since the 12-month line is up, we can expect the 13-week to be in an uptrend—and so it proves.

But the 13-week trend information doesn't stop there.

Figure 7.3 is a 13-week chart of the DJIA. The move from 11,908 to 7,181 is deemed to be a downtrend. It is so deemed because the 12-month line turned down. Note that at no stage did we get a WPC on the 13-week. And, it was only at $X/A/B/C$ that we had a series of lower lows and lower highs. The lack of a clear downtrend adds weight to the idea that a congestion market will form in the 12-month.

Assuming we had a downtrend prior to October 7, 2002, Figure 7.3 shows a Normal Change in Trend pattern, changing the trend from down to up: we have had seven bars whose lows are at or above the breakout price of 9,076—that is, we have had a WPC for the 13-week.

Figure 7.4 is the zoomed picture. Not only has the market given a WPC, but it has also given an LCC of +3. Both suggest a high probability that the DJIA had a change in trend from bear to bull that will result in a series of higher highs and higher lows.

FIGURE 7.3 Dow Jones Industrial, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

FIGURE 7.4 Dow Jones Industrial, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

So, we have a 13-week uptrend that has just begun: the LCC signal was given eight weeks ago and the WPC only four weeks ago. Figure 7.4 shows that the WPC occurred on September 22, 2003 and the LCC signal appeared on August 18, 2003.

2. What is the 13-week line direction?

Up.

3. Is the new 13-week uptrend likely to continue or change?

Given that the breakout has only just occurred, we can say that we are early in the 13-week uptrend; we can also say that, given our analysis, the minimum target is 10,896 at the 12-month 78.6% level. Accordingly, we can expect the 13-week uptrend to continue.

Is the 13-week line likely to continue heading north, or could it turn and head south?

At this stage, there is some probability that the 13-week line could turn down.

The breakout following a six-month congestion has been tepid. The market spent nine weeks going sideways after the first break above 9,076. This suggests that the breakout lacked conviction; to attract the conviction necessary to start the uptrend in earnest, we need to see a re-test of the breakout point.

If the line test were to occur, would it cast doubt on the 13-week trend?

In this quarter, if the 13-week line did turn down, it would turn down at 8,904. If the test goes no lower than 8,839, the line could turn down without generating any doubts about the uptrend. Why do I say this?

- We have our WPC and LCC.
- We have accepted prices above the maximum extension point.
- The 13-week line turn will be effected at 8,904. No doubt will be cast on the 13-week uptrend unless the market accepts prices below the lower boundary of the Primary Sell Zone at 8,839 (see Figure 7.5).

Thus, I conclude that the 13-week line may turn down and we can still have a confirmed and doubt-free uptrend. The current momentum and state of the 18-day and 5-day trends will provide information that will confirm or cast doubt on our initial assumption that the 13-week line may turn down and re-test the breakout point.

Next, we ask the final 13-week question on our checklist.

4. Where are the 13-week support and resistance levels?

Figure 7.6 shows two resistance areas. The first is the 78.6% level of the [X]/[A] range; the second is the MIDAS line. Note that MIDAS has held every rally in this down leg. Of course, we do expect it ultimately to give way; if we are to see a 78.6% retracement in the 12-month, then MIDAS

FIGURE 7.5 The Primary Sell Zone at 9076 to 8839
Source: Graphics used with permission from *Market Analyst*.

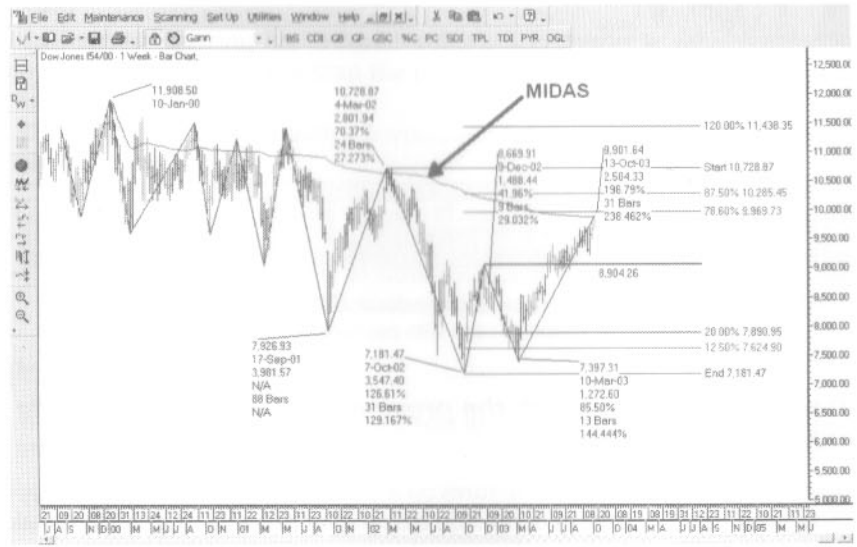


FIGURE 7.6 Dow Jones Industrial, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

must give way. Nevertheless, its ability thus far to contain prices must be respected. If the 13-week is to turn down, this would be an appropriate zone.

We can say that the range 9,901 to 9,969 is resistance; another area would be the Primary Sell Zone of 10,285 to 11,438.

Five-Day Time Frame

1. Do we have a change in trend pattern?

Let's now turn to the 5-day to see if we can glean clues and tidbits on the possible 13-week line turn. Figure 7.7 shows that the breakout price action was composed of two 5-day congestion zones, *A/I* and *C/F*. At *F* we may have the start of an impulse move.

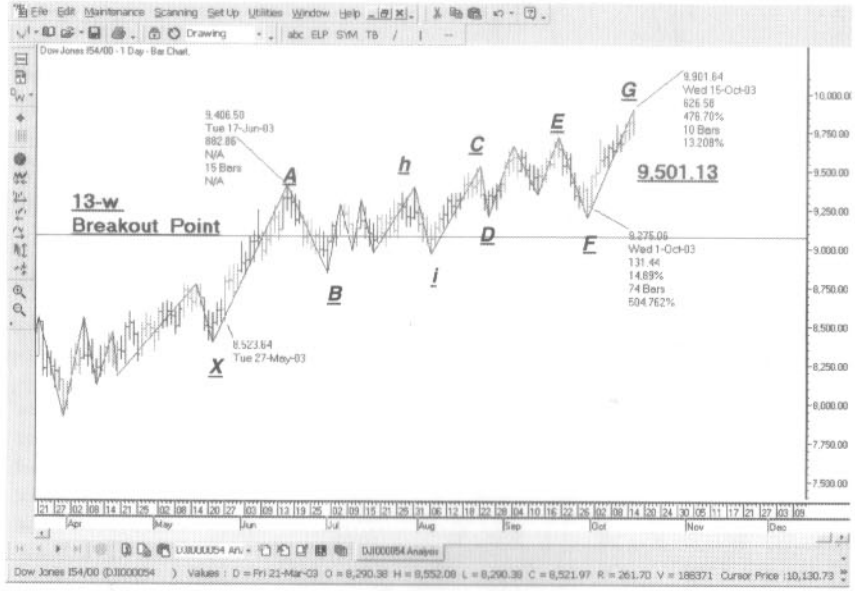


FIGURE 7.7 Dow Jones Industrial, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

2. Does a comparison with the previous impulse move indicate continuation or change?

The presence of two sideways structures on a breakout from a six-month congestion zone indicates a market in doubt: has a new uptrend really begun? To be convinced, traders and investors need to see a strong impulse move beginning from *F*.

How does the current impulse move from October 1, 2003 to October 15, 2003 (F/G) compare with the impulse move prior to the breakout (X/A)? (I chose X/A as it was the first impulse move prior to F/G.)

Figure 7.8 gives us the answer: the bars are "invisible," so you can read the statistical data.

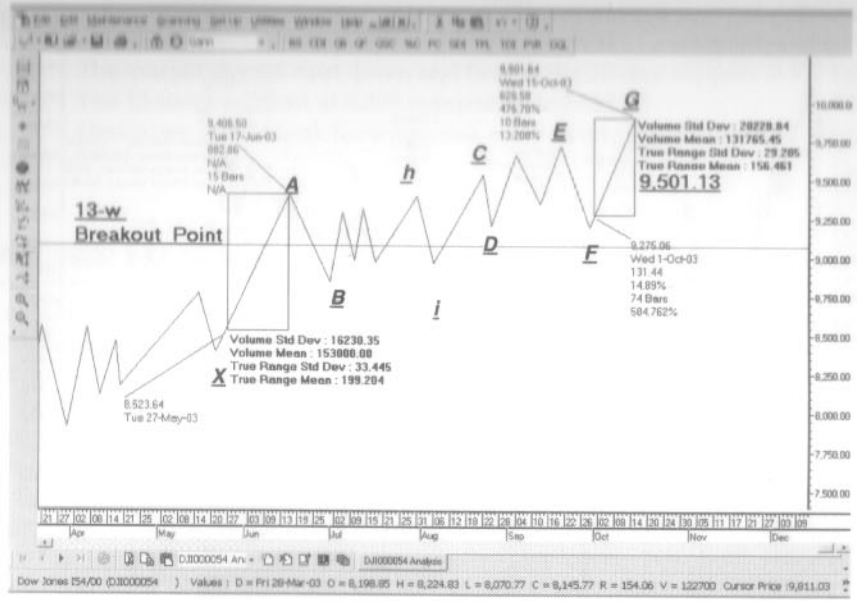


FIGURE 7.8 Dow Jones Industrial, Cash, Weekly
Source: Graphics used with permission from *Market Analyst*.

The current upswing has reduced volume and range. In other words, this upswing has less momentum than the previous swing and suggests this market is "tired."

After analyzing the 12-month, 13-week, and 5-day, we can draw the following tentative conclusions:

- The new 13-week uptrend is likely to remain intact until the market reaches the 12-month resistance zone of 12,854 to 10,896.
- The 13-week line is likely to turn down and test the 13-week band: from the breakout point at 9,076, to the Primary Sell Zone support at 10,285.

Eighteen-Day Time Frame

We turn now to the 18-day, where we will look for confirmation or negation of the tentative conclusions.

1. What is the current 18-day trend?

The current trend is a potential uptrend.

- Figure 7.9 shows the early Spring that forecast the low at *E*.
- There is a WPC and LCC, but . . .
- . . . the market still has to define a series of higher highs and higher lows.

FIGURE 7.9 Dow Jones Industrial, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

2. Is the trend in its infancy or is it mature?

The trend has just started (is in its infancy): we have just had a WPC and LCC.

3. Is the trend likely to continue or to change?

Given that the 18-day trend has just begun, we would normally expect the uptrend to continue, especially since the 12-month line, 12-month trend, 13-week trend, and 13-week line are all up. However, if the 13-week line turns down, then the 18-day will at least attempt to change its trend. In that case, we can expect the low 9,199 to be breached *before* the 13-week uptrend reasserts itself and again turns the 18-day trend and 18-day line up.

4. Is the 18-day momentum indicating trend continuation or change?

This question is irrelevant at this stage of the trend.

5. Are any potential changes in trend patterns unfolding?

No.

Since the current 18-day line direction is in the same direction as the trend, questions 7 to 10 don't apply.

Summary

1. The market should turn down and breach the 18-day support at 9,199.
2. The 13-week support at 8,839 is expected to hold.
3. Hence, we would look for a low-risk entry below 9,199 to 8,839.

ANALYSIS: EXAMPLE 2

As I said at the start of this chapter, this is the fun part of the book. It's the payoff for learning the basics. When I started Go-Ju Kai karate lessons, I couldn't wait to get on the *kumite* (free-sparring) floor. But my instructor, Merv Oakley, belonged to the old school, which held that the minimum grade for free-sparring was a green belt. Later I was thankful for his rule. Without the basics under my belt, free-sparring would have led to numerous bad habits.

So it is with trading. Get the basics right, and profits will follow. (Though sometimes profits come later, rather than sooner. And, if you are as slow a learner as I was, profits will come a lot later!) One of the "basics" is getting the trend right. You want to get this right, simply because it puts the probabilities in your favor.

Getting the trend right also means getting right the end of the correction. The trend of one time frame is merely a correction in the first higher time frame. For responsive traders (traders who sell on strength and buy on weakness), getting the end of a correction right is as important as getting the trend right.

The "basics" also include knowing what your best trades look like. There is a principle in business known as the 80/20 Rule. It says that 20% of our sales result in 80% of our profits. Traders, especially discretionary traders, ought to know what that 20% looks like. I know that my best trades come from trades as the trend changes, or early in the trend change—shortly after the market signals a WPC, etc. My worst results come from mature trends. Most times, I avoid trading marginal trades. But sometimes, I convince myself that this time it will be different; this time the market will go farther than the statistics suggest.

Well the market, being who she is, occasionally does go farther and I find that I got on not in the late stages of the trend, but in the early to middle stages. (I discover this after the market has completed the move, of course.) But most times, the statistics I gather prove correct. They prove that I was engaging in wishful thinking. What they also show is that the occasional winners don't justify the more frequent rushes of blood to the head; I would be better off sitting on my hands and waiting for the 20% profiles.

Well, there's hope. Each year, the number of my "silly" trades diminishes. If the rate of change continues, next year will be a "perfect year." We'll see.

The point of all this is that I wouldn't know what my 20% trades looked like if I didn't use the tools I have explained in this book. As Pete Steidlmayer said: "Know the direction, know if the direction will continue or change, and the game is yours."

Let's look at another example: a trade I took in the US 30-year bonds in June 2003. In this trade, I missed the rally and waited patiently for the sell that would come. I took a short trade on June 17, 2003 at 119 14/32. We'll see why. But before I review the trade, please note that I use CSI's Perpetual contract for my trend analysis. I find it gives me better results than using a Nearest Futures Month contract.

Twelve-Month Time Frame

The questions I ask of the 12-month line direction are:

1. *What is it?*
2. *Where are its support and resistance zones?*
3. *Is the trend likely to continue or to change?*

To determine the direction of the 12-month line, we need also to consider the other two questions.

At the time, the US bonds in the 12-month was a "no brainer." Figure 7.10 shows the 12-month line direction, as well as its resistance and support zones, in June 2003.

FIGURE 7.10 US 30-year Bonds, CSI Perpetual, Monthly
Source: Graphics used with permission from *Market Analyst*.

In Figure 7.10 we have a log chart of the 12-month swing in US bonds. The outer trendlines represent the upper resistance and lower support boundaries. The inner trendlines represent the lower resistance and upper support boundaries.

Figure 7.10 shows that in June, the 12-month line direction was up and we were in a resistance zone. The remaining question for the 12-month was whether there would be line continuation or change. For that we would have to turn to the 13-week and 18-day, to see how they were reacting to the 12-month resistance zones.

Incidentally, if you were wondering what the arithmetic chart would show, then take a look at Figure 7.11.

FIGURE 7.11 US 30-year Bonds, CSI Perpetual, Monthly (Arithmetic Scale)
Source: Graphics used with permission from *Market Analyst*.

I'll start the 13-week trend analysis from the 12-month swing low on March 11, 2002 (see Figure 7.12).

Thirteen-Week Time Frame

The questions asked are:

Q: *What is the 13-week trend? What is the 13-week line direction?*
A: Both are down.

Q: *Are we at 13-week support?*
A: Not that I can see.

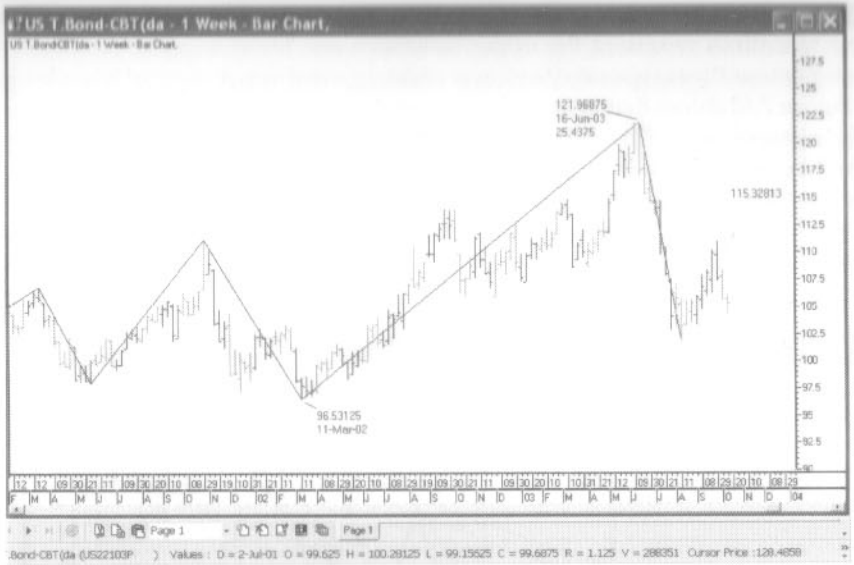


FIGURE 7.12 US 30-year Bonds, CSI Perpetual, Weekly
Source: Graphics used with permission from *Market Analyst*.

Q: *Is the trend or line direction likely to continue or to change?*
A: The momentum between the swings was equivocal. In the later swing, the range went up from 2.3 to 2.6, while the volume went down from 470,051 to 393,960. This is slightly bearish (range up, volume down), but the change is too small to form a definitive view.

At the end of the 13-week analysis, I haven't added to my store of information. The question is still whether the lower time frames will provide clues as to how the market will react to the 12-month zones. Perhaps, if we compare the last two impulse swings, that may reveal something.

Figure 7.13 shows the statistical data between the last two impulse swings. Unfortunately, the comparison did not add anything to the analysis.

Eighteen-Day Time Frame

The 18-day (no chart) didn't add to my store of knowledge. Clearly, the trend was up, as was the line direction. The momentum swings were the ones we considered in the 13-week.

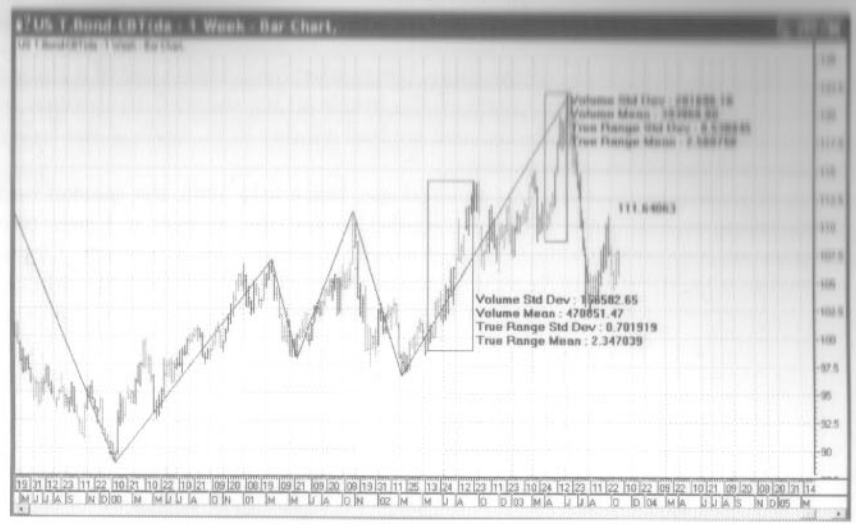


FIGURE 7.13 US 30-year Bonds, CSI Perpetual, Weekly
Source: Graphics used with permission from *Market Analyst*.

Five-Day Time Frame

Figure 7.14 shows the 5-day price action on June 16 and 17. I have drawn in 20% of A/B and 10% of X/A.

FIGURE 7.14 US 30-year Bonds, September 2003, Daily
Source: Graphics used with permission from *Market Analyst*.

Do we have a change in trend pattern?

The 5-day was a gold mine of information. The market had broken out of a zigzag correction on June 10. The momentum on the breakout leg showed an increase in volume and range. We had a +3 LCC and we had a 3-day WPC (50% of the 5-day swing). Everything looked strong. But . . .

. . . the 12-month resistance zone worried me. Since July 1984, the market had been respecting the channel zones. I decided to sell the market if I saw two consecutive, strong, bearish days down. It was a contrarian approach. Given the bullish technicals, two strong days down would be a sign that the market was again respecting the trend channel. In addition, each time the market had approached the top of the channel, it had a strong sell-off—the secondary top on the 18-day Normal Change in Trend on most previous occasions had formed a long way down from the highs.

In Figure 7.15, I have zoomed into the price action from June 16. The contract in this figure is the September 2003 contract, the active month at the time. The mean range prior to June 16 was 31 tics. On June 16 and 17, the range was 50 tics and 43 tics, respectively. Given that:

- the market was trading at the 12-month zone; and
- all the signs on and after the June 10 breakout were bullish,

the price action of June 16 and 17 ought not to have happened. The fact that it did, indicated that a top was in.

FIGURE 7.15 Five-day Swing showing the Price Bar of June 16 and 17 in detail
Source: Graphics used with permission from *Market Analyst*.

ANALYSIS: EXAMPLE 3

In this final example, we will throw in the secondary tools. How about gold? I'll use the CSI Perpetual Default for 12-long-term and 13-week. For the 18-day and 5-day, I'll use the active month. Figure 7.16 shows the position of the 12-month trend.

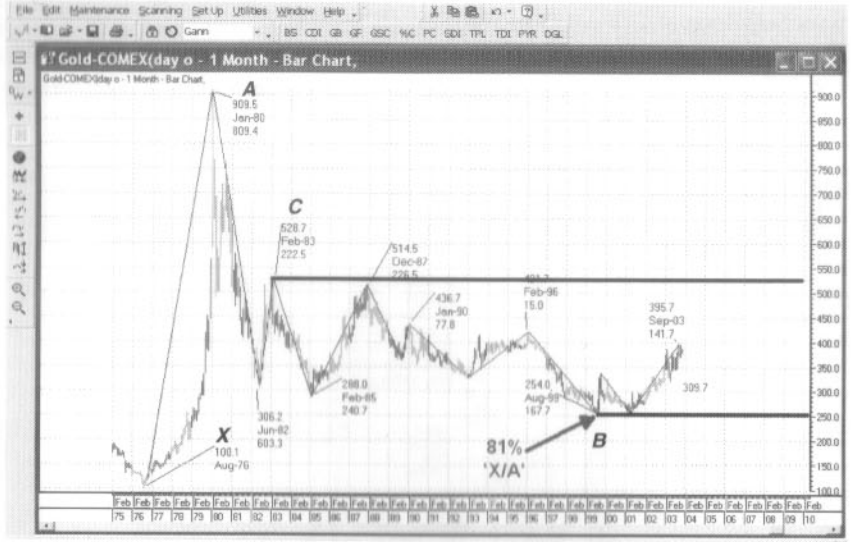


FIGURE 7.16 Gold, CSI Perpetual, Monthly
Source: Graphics used with permission from *Market Analyst*.

Twelve-Month Time Frame

1. What is the line direction?

The line direction is up. But the 12-month provides even more information.

Figure 7.16 shows that gold has formed a possible congestion market between *X* and *A*. I say this because *B* has retraced more than 78.6% of *X*/*A*, making the congestion scenario a high-probability event.

Notice, too, that while *C* has remained stable since it formed in February 1983, *B* has slowly been expanding. For reasons I shall make clear in a moment, the price action on the 12-month suggests a move to 495 to 530 for the current 12-month structure.

2. What are the resistance levels?

Resistance levels are the 430 to 437 area.

3. Is the line direction likely to continue or to change?

Why do I believe the 12-month chart is indicating a structural target of 495 to 530?

I draw your attention to the price action in February 1985. The market broke below the previous low at 306 but returned to congestion rallying to the Primary Sell Zone of 306 to 529. In August 1999, the market broke below the February 1985 low at 288 and has since returned to congestion, suggesting a move to the Primary Sell Zone of C/B—495 to 530 (529–[529–254]/8).

The statistics for the internal swings between C/B are also interesting. Figure 7.17 shows the data.

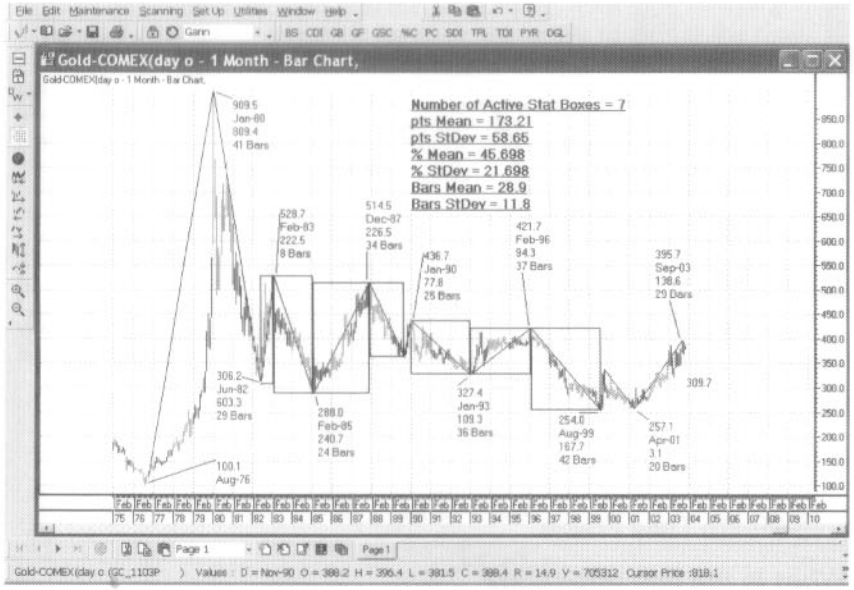


FIGURE 7.17 Gold, CSI Perpetual, Monthly
Source: Graphics used with permission from *Market Analyst*.

If we ignore the outlier of eight months, the average move lasts 29 months, and the first standard deviation is +/−12. In other words, the average move takes between 17 and 41 months. This current move has taken 29 months.

Again, if we discard the outlier of 603 points, the average move is US$173 with a standard deviation of 59. This means the average move lies between 114 and 232. The current move is US$139.

Both time and price are average, so we are unable to draw any conclusions about continuation or change based on the 12-month swing.

Note: Although the sample size is very small, that fact is offset because this is a congestion market where both price and time exhibit a great degree of reliability. Experience has shown that, in this context, we can draw reliable conclusions despite the small population.

Thirteen-Week Time Frame

1. What is the 13-week trend?

Figure 7.18 is the 13-week. Let's see what that has to offer. Given that the 12-month line is up, we can expect the 13-week trend to be up. We start the 13-week swing from the last 12-month low in April 2001.

FIGURE 7.18 Gold, CSI Perpetual, Weekly
Source: Graphics used with permission from *Market Analyst*.

The 13-week shows a complex three-wave structure that is at the cusp. There is either an Upthrust or a Failed Upthrust in the making. A Failed Upthrust occurs when the market accepts prices above the maximum extension, leading to a continuation of the uptrend. The Upthrust signal is complete when the market accepts prices below the Primary Sell Zone, leading at least to a move to the Primary Buy Zone of $0/A$. As the levels are so important, we need to turn to the December 2003 contract (see Figure 7.19).

The December contract has a Failed Upthrust occurring when the market accepts prices above 401, and confirmation of the Upthrust if it

FIGURE 7.19 Gold, December 2003, Weekly
Source: Graphics used with permission from *Market Analyst*.

accepts prices below 379. Hence, we obtain the following information from the 13-week:

- The 13-week trend is up.
- There is a doubt about its continuation or change. Perhaps the lower time frames will assist.
- The critical levels are the maximum extension zone of 401 to 395 (basis December 2003) and the lower boundary of the Primary Sell Zone, 379 (basis December 2003).

2. What is the 13-week line direction?

The direction is up, but in this case this question is less important than the trend direction.

Figure 7.20 shows the 18-day and 5-day structures. They add little to our store of knowledge.

On the 18-day, the market has broken out of congestion, but it is unclear if prices are being rejected or accepted at the higher levels.

How about the secondary tools?

- *Trader Vic Trendline:* Suggests momentum to the upside is intact. Figure 7.21 shows the trendline still intact after the current reaction high was made. I have placed a time price label on the lows I used for the trendline.

FIGURE 7.20 Gold, December 2003, 18-day/5-day
Source: Graphics used with permission from *Market Analyst*.

FIGURE 7.21 Gold, December 2003, 18-day
Source: Graphics used with permission from *Market Analyst*.

- *Comparison Volume:* We cannot use this, as the 5-day swings are not in sync. The rectangle in Figure 7.22 marks the two 5-day swings. The ultimate 5-day swing in the latest rectangle is clearly not impulse mean.

FIGURE 7.22 Gold, December 2003, 18-day/5-day
Source: Graphics used with permission from *Market Analyst*.

The penultimate wave is impulse mean, but the earlier rectangle is not only a 5-day but also an 18-day swing. Consequently, you aren't comparing apples with apples.

- *The Market Profile Advance Warning:* It doesn't apply. It applies only when there is an impulse structure followed by congestion. Here we won't know if there is an impulse structure until after the market decides if it will accept or reject the new highs.
- *WhisperNumber:* Gold is just oversold. Given the equivocal nature of the technical picture, I would rely on the index only if sentiment was very oversold.

So, the secondary tools are of no great assistance. The one thing we can say is: keep an eye on the market, as it may soon offer an opportunity one way or another.

This analysis is very different than the previous two. The central question—whether the market was going to prove the 13-week Upthrust true or false—became apparent at the 13-week level but was unresolved as we chunked down to the 18-day and 5-day.

CONCLUSION

The principle of immersion holds as true for trading as for any other endeavor. The more charts you pore over, and the more distinctions you learn and internalize, the easier the analysis becomes. Of course, being a good analyst doesn't mean

you will make a good trader. But getting a feel for what the market will do will certainly make you one, provided you execute your plan consistently.

For me, successful trading isn't only about being disciplined and following rules. It's also about learning to get in tune with the market; about knowing how to sift the important information from the unimportant; about creating scenarios and comparing them with market action to see if a trade is warranted; about exiting when a trade fails to prove itself; and about managing a trade and managing the risk. Successful trading is about getting to know myself, how markets work, and how the world operates. Most of all, it's about enjoyment—the winning *and* the losing—and it's about achieving my dreams.

I hope you will achieve your dreams through trading. There is a lot of work, and much frustration among the victories. But, in the final analysis, I believe you'll find it will all be worthwhile.

Profitable trading: Manage the trade, manage the risk, and all will be well.

APPENDIX

Formulas for Constructing Barros Swings

The smallest swing in any time frame is the "one" period. In the Barros Swing, these are drawn differently than the other swings in the same time frame.

ONE-PERIOD SWINGS

To draw a one-period swing, start at an extreme low or high. For the purposes of this illustration, let's assume we start from a low.

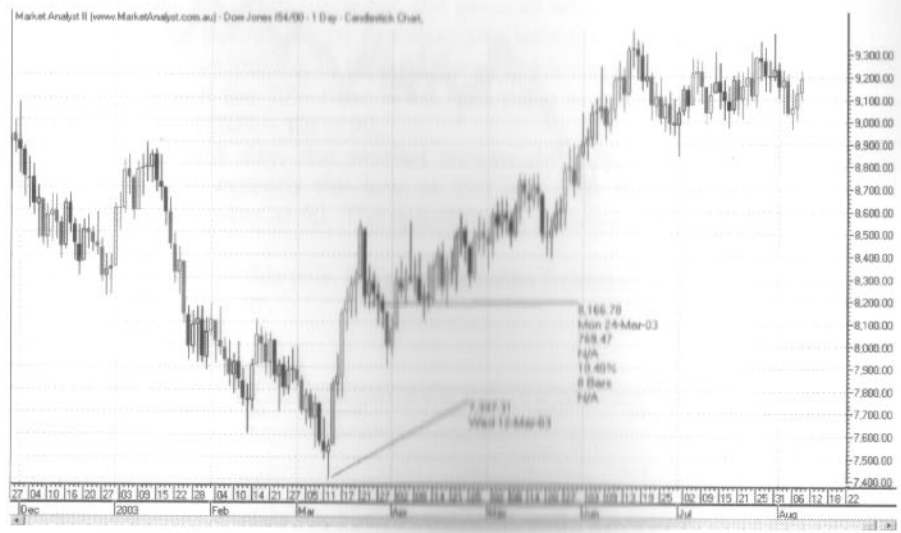


FIGURE A.1 Dow Jones Industrial, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

In Figure A.1, let's say we start the swing on March 12. From the low, we draw a line from its low and continue to do so until Friday, March 21. On Monday, March 24 we have a low below the previous day's low. Accordingly, we draw the line down from the high of Friday to the low of Monday and continue to do so until we get a day where the high exceeds the previous day's high. At that point, we draw the line up—and so on.

Inside days are ignored.

For outside days, the drawing of the line is delayed until the day following the outside day. If the high of the outside is exceeded, we draw the line up; if the low is exceeded, we draw the line down.

SWINGS FOR PERIODS GREATER THAN ONE

Three-Period Swing

Using the same data, we start from the low and turn the line up when *we exceed the highest high of the past three days (including today) +10% of the adjacent one-period swing.*

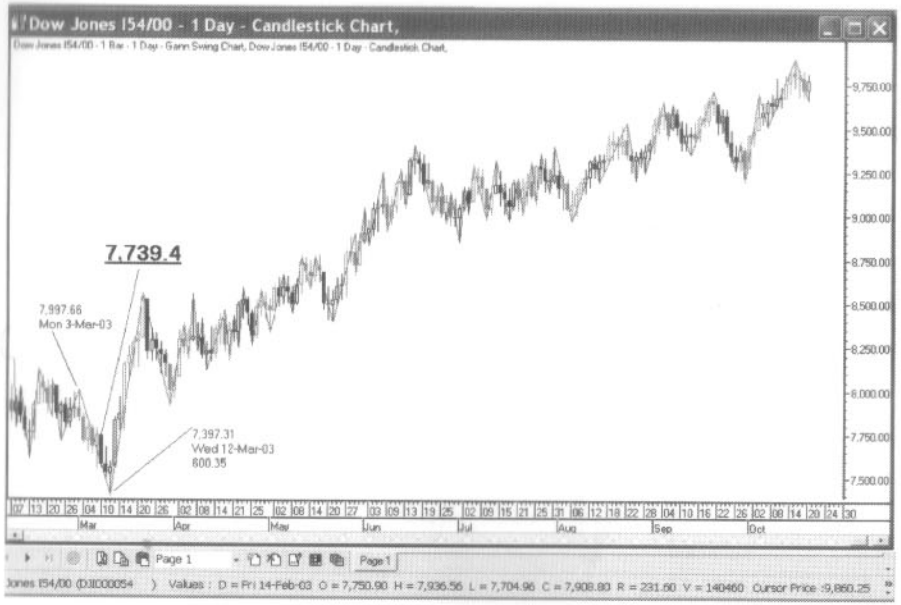


FIGURE A.2 Dow Jones Industrials, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

In Figure A.2, the lines represent one-period swings. At the completion of trading on Wednesday, March 12, the 3-day line will turn up on the breach of the highest high of the past three days (including today); viz, 7,739.4 + 60 (10% of the one-period swing, which was 600.35 points). The line will continue up until the market takes out a low that is the lowest low of the past three days +10% of the adjacent one-period swing.

Reverse to turn the line down.

Five-Period Swing

The same principles apply in the case of a five-period swing, except that the filter used is 10% of the adjacent three-period swing and the line turns when the five-period extreme is exceeded +10% of the adjacent three-period swing.

Note that this means that for every time frame, we first need to calculate the one-period swing irrespective of the swing size we are considering.

ADDITIONAL RULES

To circumvent the situation where the market fails to move sufficiently to turn the line because it fails to reach the filter, there are two additional rules.

1. The swings (except for the 3-day) represent one-period swings of high time frames—for example, the five-day swing represents the one-period weekly swing. Hence, any time we turn the one-period weekly line, the 5-day line must also turn. (I have outlined the various relationships below.)
2. For a downswing, the price at which the line turns up can move down but not up; in an upswing, the price at which the line turns down can move up but not down. For example, let's say the line has been going up and we are looking to turn it down. The lowest low of the past five days is 100 and the 10% filter is 10. The price at which the line would turn would be (100 – 10) = 90.

   The next day, the market moves down and gets to 97. In other words, it exceeds the low at 100 but fails to reach the low minus the filter price at 90. The question is: *At what price would the line now turn?*

   Because of this rule, the price remains frozen at 90; otherwise, it would be 97 – 10 = 87.

PERIOD RELATIONSHIPS

Daily data

5-day = 1-period weekly
18-day = 1-period monthly

Weekly data

13-week = 1-period quarterly

Monthly data

12-month = 1-period yearly
30-month = 1-period 2.5-yearly
60-month = 1-period 5-yearly

HOW TO MANUALLY CALCULATE THE MARKET PROFILE VALUE AREA

Steidlmayer calculates the bulge in a slightly different way, to generate, statistically, the first standard deviation.

1. First add all the TPOs (time, price, opportunities).
2. To calculate the "bulge," the first standard deviation:
   - Multiply the sum by 0.70.
   - Subtract the product from the line containing the greatest number of TPOs (Point of Control). Now compare the two lines above and below the Point of Control. Sum the two lines containing the greatest number.
   - From the remaining product, deduct the sum.
   - Eliminate the lines whose TPOs have been summed.
   - Of the remaining lines, compare two lines above and below the Point of Control and repeat the process.
   - Continue the process until 0.68 of TPOs is reached.
   - To calculate the third standard deviation, multiply the total number of TPOs by 0.70 and repeat the process until 0.70 is reached.

   This completes the calculation for the first standard deviation.
3. To calculate the third standard deviation, multiply the total number of TPOs by 0.95 and repeat the process.

CREATING BARS FOR VALUE CHARTS

For a full understanding of the theoretical underpinnings, read Mark Helweg and David Stendahl's *Dynamic Trading Indicators* (John Wiley & Sons, 2002). The following is quoted from that source (p. 27).

To create the bars for the value charts:

1. *Create a floating axis.*
   The floating axis is simply calculated by averaging the median prices from the current bar and most recent four bars (five bars total). The median price is calculated as follows: (high+low)/2. After calculating this value for each price bar, we simply take the average of five bars to create our floating axis.

2. *Create a synthetic bar.*
   The relative high can be calculated by subtracting the floating axis from the high . . . Simply repeat the conversion process for the open, high, low, and close to calculate the relative high, relative low, and relative close.

3. *Adjust price to changing volatility.*
   (After calculating the relative open, relative high, relative low, relative close) by the dynamic volatility unit . . . The dynamic volatility unit can be calculated by first taking a five day average of the daily range . . . After calculating the five day average . . . (multiply this average) by 0.20 or 1/5 . . .
   . . . Repeat this process to calculate the . . . volatility units for each additional trading day.

Resources

The providers listed below have products that produce the Barros Swing and other tools that I use.

Market Analyst

www.Market-Analyst.com

Tel: +61 7 3018 7507

Fax: +61 7 3319 8952

WhisperNumber

www.whispernumber.com/premium_signin.jsp

david@whispernumber.com

Erlanger Squeeze Play

www.erlangersqueezeplay.com/page/esp/

Market Vane (Bullish Consensus)

www.marketvane.net/

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