

Trading for Doofuses v2

by Bobh

What I'm going to attempt to do here is explain how I view the markets and how they move, touch upon entries, talk a little about trade management and then dissect a day or two's trading to try and pull all the pieces together in a way that I hope makes sense.

Markets can only do two things - they can congest/compress or expand/move directionally, and when they move directionally they usually trend. I like to trade when a market is getting ready to breakout of compression/range or when it is trending, and usually leave the sideways stuff alone. Others may do the opposite or both but it doesn't matter as long as you know what you like and can recognize, adapt & execute.

Markets are controlled by people and people are creatures of habit so there are repeatable 'structures' that can be exploited. And I think it's important to think in terms of structure as opposed to 'patterns' because a pattern implies specificity such as the same # of bars.

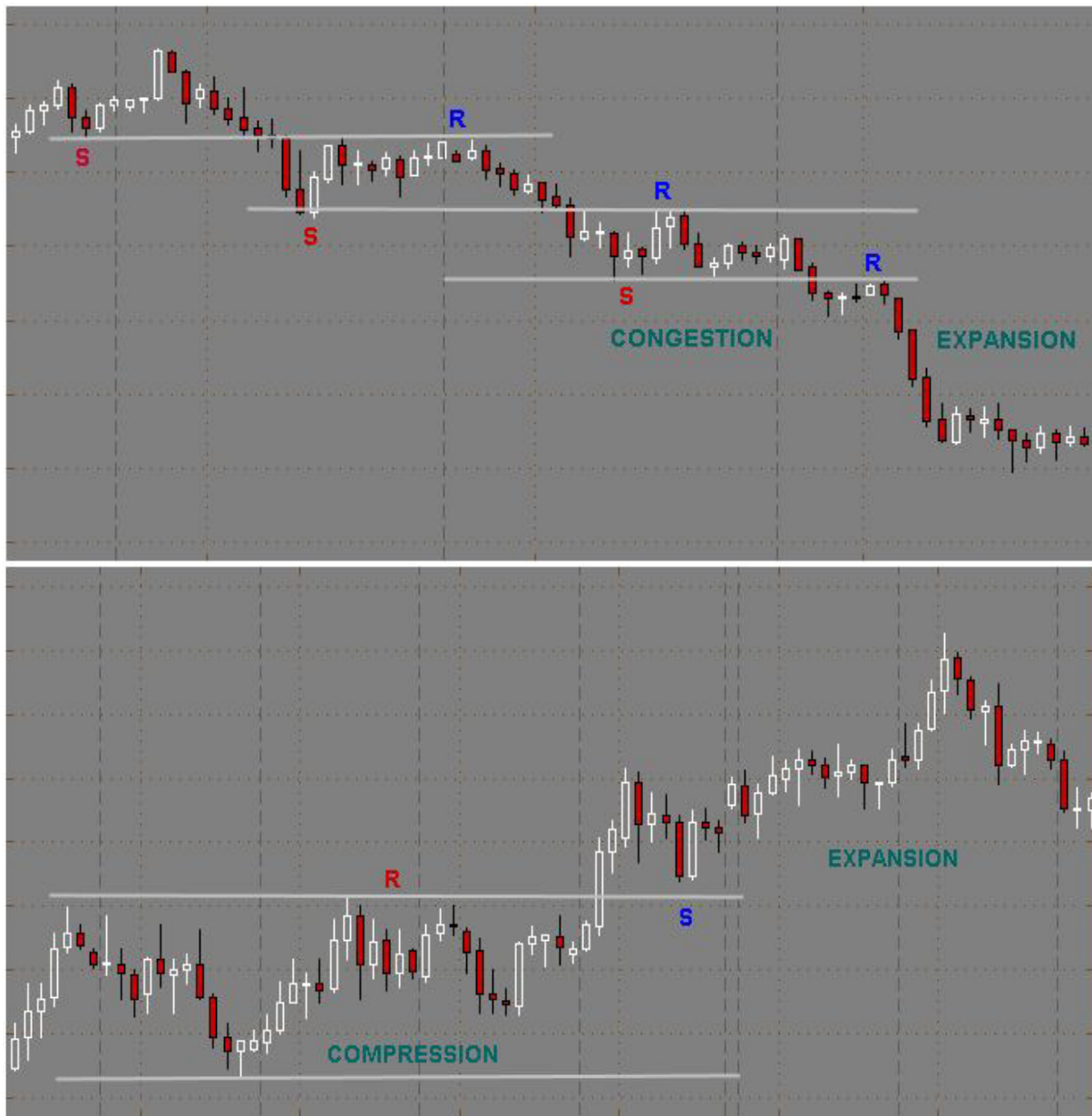
A market is likely to begin compressing after it has made a large move and is likely to make a large move after a period of congestion/compression. And generally speaking the longer the period of congestion/compression the larger the ensuing move.

The markets are an ongoing turf war between two combatants - bulls & bears. Each occupy territory (S/R levels) they look to defend and each covet territory their enemy holds. For a market to move directionally one side has to capture enemy territory and consolidate that gain which will then force the other side to retreat to its next stronghold (S/R level). Or as everyone claims to understand → prior support broken becomes resistance:



Sometimes this process is quite elegant and other times it's headache inducing, but it's a very important concept that comes into play in every aspect of trading. However, I know from experience that just about everyone says they **"understand"** it, but once you start working with them you discover they actually know very little and/or are not applying it any productive way. And I would find this out by simply asking them to send me an hourly chart of their favorite market with all the S/R levels identified and the Key S/R levels highlighted. I'll touch upon this again later but for now let's take it one step further.

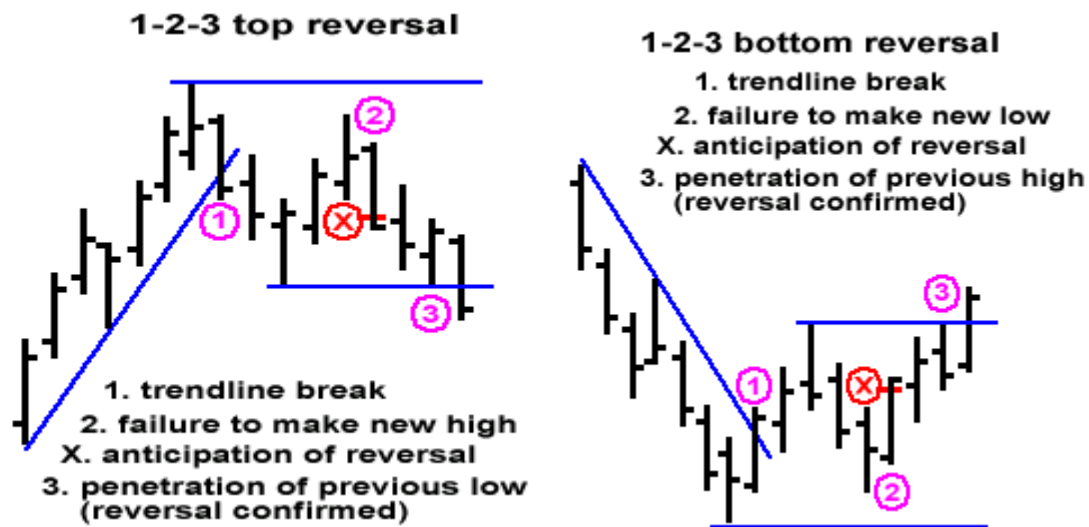
The more times an area has been "attacked and rebuffed" (tested and held) the more important it becomes, and I call these Key S/R levels (the top or bottom of a lengthy range would be good examples). And when one of these key levels is "captured" (not just breached) a large move almost always follows. I think it also makes sense that the longer the timeframe these Key levels form the more important the level becomes.



OK, let's touch on entries for a minute. Now I'm not going to detail exactly how I enter every trade because it's not relevant, would get a little tedious, and there's more than one way to trade them which is something you have to decide for yourself. What is relevant is the structure so that's what I'm going to cover.

I also want to say that people spend way, way, way too much time on entries and usually because they're looking for ways to reduce risk & filter out losers. IMO you're just chasing your tail and that time would be better spent learning how to read a chart better & learning how to manage a trade better so you're able to maximize the good ones. You'll also be surprised at the new things you're able to "see" once this happens, and one of them will be ways to fine tune entries and exits. In any event, at some point you need to suck it up, pick your poison and get on with things.

Since I believe that a market can only do one of two things it shouldn't surprise you that I only use a couple of setups. The first one I call a 123 which I was told years ago looks like a Ross Hook. At the time I wasn't familiar with Joe Ross's work but I am now and would agree. I also have a very high opinion of his work. You can read more about it in Joe's Law of Charts e-book which you can get for free at his website - <http://www.tradingeducators.com/>. It also resembles Trader Vic's 123 setup which you can read about here - <http://www.trading-naked.com/123-reversal.htm>. I don't trade it quite the same way that either of them suggest but if you like the setup you can figure out what works best for you.



Next on the menu we have Flags or Retracements which are really nothing more than mini versions of the compress/expand principle discussed above. These are the best trades in terms of risk/reward and win % (IMO) but they do come in a variety of shapes, sizes and lengths which I know can prove extremely frustrating for those folks who like to operate in a very precise manner. But IMO trading isn't about rules and precision, **it's about judgment and guidelines** so you're going to have to loosen up a bit.

I prefer to wait and let the market show me when it's ready to resume the move instead of using any calculations or trying to pick off turning points. Plus if a retrace gets too deep (say more than 50%) I start to lose interest and will treat it with a lot more caution. Anyway, I want to show a couple examples of my favorite type of retrace and it just so happens that we've already covered the structure.



If those look a lot like the Support:Resistance diagram above it's because they are in essence one and the same with the only difference being that one is a diagram and the other is real Price Action. Granted it takes some time and practice to learn how to recognize, anticipate & time these properly, and this is just one of several forms a retrace can take, but if you study enough of them you'll discover which kind(s) you like and how best to trade them.

That brings us to **Trade Management**. I saved this for last because it's **the** most important part of trading, but it's also the part that nobody can really help you with except yourself. All anyone can do is help get you to the point where you know what you need to do - the rest is up to you because it's execution/post-fill where most people fail. Plus you don't really have a lot of options like you do on methods/timeframes. You can:

- scale out at fixed intervals
- scale out and trail last unit
- all in/all out at a fixed objective
- all in/all out via trail
- incorporate add-ons (which some would call scaling in)

I suppose you could make it more complicated but what would be the point? Let's briefly touch upon each one.

Scale out at fixed intervals - This is probably the most popular method (especially among scalpers) but I believe this is a very inefficient way to trade because it does not maximize good trades and as a result puts the math against you. Let's look at a typical index trade on YM to illustrate this:

Contracts: 2
 Stop loss: 15 ticks (\$75 per contract)
 Obj1: 10 ticks
 Obj2: 20 ticks

And you usually see the Stop moved to b/e after Obj1 is hit which is a very big **NO-NO**.

In the above example the max gain for a winning trade would be 30 ticks & the max loss is also 30 ticks, so in essence you are risking what you're trying to make or using a risk:reward ratio (RRR) of 1:1. Under this scenario you will need to run about a 55% win rate to breakeven and cover costs. Or to look at it another way - you are **working for free** 55% of the time = **NO THANKS**. Let's look at this in spreadsheet form, and use a block of 100 setups using a 2-lot with a \$5 rate, with every trade being a max gain/loss (unlikely) of \$100 per contract, no slippage (unlikely) and every trade is taken (when pigs fly).

Win %	Profit on Winning trades	Loss on Losing trades	Gross Profit	Comms	Net Profit
30%	6,000	(14,000)	(8,000)	1,000	(\$9,000)
35%	7,000	(13,000)	(6,000)	1,000	(\$7,000)
40%	8,000	(12,000)	(4,000)	1,000	(\$5,000)
45%	9,000	(11,000)	(2,000)	1,000	(\$3,000)
50%	10,000	(10,000)	(0)	1,000	(\$1,000)
55%	11,000	(9,000)	2,000	1,000	\$1,000
60%	12,000	(8,000)	4,000	1,000	\$3,000
65%	13,000	(7,000)	6,000	1,000	\$5,000
70%	14,000	(6,000)	8,000	1,000	\$7,000
75%	15,000	(5,000)	10,000	1,000	\$9,000
80%	16,000	(4,000)	12,000	1,000	\$11,000
85%	17,000	(3,000)	14,000	1,000	\$13,000

Here's another question - the above is largely theory so do you think reality is going to be better or worse?

There are also a few "hidden" negatives to this approach which can be found on the psyche side of the trading equation. For example, let's say the day starts out poorly. The first trade is a good setup that doesn't work and the second one is a marginal trade that was really an attempt to get back the loss on the first trade right away. Yeah, yeah, I know this never happens to anyone but me.....

So, the net result is you start the day with two max loss doinks and are down 60 ticks plus comms. Now even if the next two trades are max gain winners you will still be down comms on 8 RT's, so you really need three winning trades in a row just to get above breakeven for the day. Sooooooo, do you think this will have any affect on your ability to execute? I promise you it will.

Before we move on to the next one I'm going to make a slight detour to cover what I call the **probability trap**. This often happens when someone does backtesting and comes up with something that produces a high expectancy rate normally in the 80-85% range. And then they use this high "expectancy" to justify using a RRR of 2:1 or 3:2 and I've even seen it as ridiculously high as 3:1 where you would need to run 80% just to b/e. Let's take a look at a spreadsheet when you risk 4 to make 2, or a 2:1 RRR.

Win %	Profit on Winning trades	Loss on Losing trades	Gross Profit	Comms	Net Profit
30%	3,000	(14,000)	(11,000)	1,000	(\$12,000)
35%	3,500	(13,000)	(9,500)	1,000	(\$10,500)
40%	4,000	(12,000)	(8,000)	1,000	(\$9,000)
45%	4,500	(11,000)	(6,500)	1,000	(\$7,500)
50%	5,000	(10,000)	(5,000)	1,000	(\$6,000)
55%	5,500	(9,000)	(3,500)	1,000	(\$4,500)
60%	6,000	(8,000)	(2,000)	1,000	(\$3,000)
65%	6,500	(7,000)	(500)	1,000	(\$1,500)
70%	7,000	(6,000)	1,000	1,000	\$0
75%	7,500	(5,000)	2,500	1,000	\$1,500
80%	8,000	(4,000)	4,000	1,000	\$3,000
85%	8,500	(3,000)	5,500	1,000	\$4,500

As you can see you need to run 70% just to b/e - in theory. If you can automate something like this 100% then maybe it's worth a try but otherwise don't engage in this silliness.

Scale out and trail last unit - This is a better version of the above and should yield better results over a meaningful number of trades because it allows you to maximize some good moves on part of your initial position. And it's even better when add-ons are used. It also allows you to "practice" which I'll come back to in a moment.

All in/all out at a fixed objective - This approach doesn't suit me but your mileage may vary. I don't believe a trade is over just because the market hits a certain point - I believe it's over when the market says it's over. It also introduces an element of boredom because you're doing the same thing on every trade. This may be considered a strength by some though, plus you can structure it so the math is on your side. But since I've never employed this method I'm not that comfortable discussing it at any length.

All in/all out with trail - This is the most efficient way to trade IMO and even more so when combined with add-ons. It allows you to attack good moves, really maximize gains and it keeps the math comfortably on your side. And I think it's the simplest way to trade because you're letting the market make the decisions for you which has many advantages both on your wallet and your psyche. Let's take a look at one more spreadsheet where the RRR is 1:2:

Win %	Profit on Winning trades	Loss on Losing trades	Gross Profit	Comms	Net Profit
30%	12,000	(14,000)	(2,000)	1,000	(\$3,000)
35%	14,000	(13,000)	1,000	1,000	\$0
40%	16,000	(12,000)	4,000	1,000	\$3,000
45%	18,000	(11,000)	7,000	1,000	\$6,000
50%	20,000	(10,000)	10,000	1,000	\$9,000
55%	22,000	(9,000)	13,000	1,000	\$12,000
60%	24,000	(8,000)	16,000	1,000	\$15,000
65%	26,000	(7,000)	19,000	1,000	\$18,000
70%	28,000	(6,000)	22,000	1,000	\$21,000
75%	30,000	(5,000)	25,000	1,000	\$24,000
80%	32,000	(4,000)	28,000	1,000	\$27,000
85%	34,000	(3,000)	31,000	1,000	\$30,000

You can easily do the math in your head with RRR but sometimes pictures help. In this case you can see we now need to run about 35% to breakeven, or we need 1 win to cover 2 losses which is a far cry from needing 2 wins to cover 1 loss.

So, which one should you choose? Well, I would suggest you start with Scale Out & Trail Last Unit and work your way up from there, and let me explain why.

When you first start learning how to trade real money you have no trading skills, and the **ONLY** way to develop these skills is by being in the market. People always talk about screen time, and it's certainly important, but market time is even more important. But when we first start out we're usually petrified being in the market and look for every possible reason to get out of a trade to relieve the stress. So we need to take steps to reduce that stress and the best way to do that is to get the trade to breakeven ASAP.

So, I think you should trade a 2 or 3 lot, take 1-2 out at the first objective (an S/R level - not a pain threshold) which should leave you somewhere around b/e, (or what some are now calling the "free trade") and then just practice managing the last contract (unit) by holding it until the market either sets up against you or hits the trailing stop. And do this on every trade because the only way to learn how to manage a trade is by managing trades. Once you get comfortable doing this you can look at more effective options.

While you're practicing it's **extremely** important that you gauge your progress using the proper measures too. **You can't use P&L** to rate your performance because you don't have the skills yet to be consistently profitable.....instead use quality of decision making both in trade selection and how you managed them. Also be careful not to curve fit the chart to how you managed the trade. What I mean is just because the market continued on after you exited does not mean you did anything wrong. Sometimes they do very irritating things like shaking you out without allowing a way back in. The only thing that matters is whether or not you made a good decision on the exit and kept the trailing stop where it needed to be. Or to put it a more simplistic way - were the decisions logical or emotional.

Stops and exits - Handling stops properly is the downfall of many traders and also an area they usually spend little time trying to improve. And it's almost always some version of moving the Stop to b/e after some arbitrary level or pain threshold is hit instead of using the chart/Price. If you're going to put your Stops in traffic like this then they're going to get run over and leave you wondering why you can never be consistent.

Now I don't have the space here to cover every nuance of how I use Stops, and I don't know how to explain experience, but I will show you the basics of how I do it in a moment. First let's think about it for a minute.....what do you want a long trade to do? For me I want to see higher highs and higher lows (duh!), and I greatly prefer when the higher highs come right away. Another way of looking at this is I want to see resistance broken and the market stay above that level because it should now act as support.

But the moves won't always be the clean, stair step variety so what determines how long a trade is valid for me are the higher lows/lower highs, and I'll stay with a trade as long as it makes them. Or how I usually phrase it - I'll stay with a trade as long as it doesn't do anything wrong. And sitting through retraces is part of the deal.

These higher lows (lower highs) - or new areas of support (resistance) the market establishes as it moves from place to place allow us to move the Stop in a sensible and consistent manner. And IMO you shouldn't move the Stop until the market lets you - no pain threshold stops, no move it to b/e at arbitrary levels or moments, etc., etc. Just wait for the market to tell you what to do. If you reach a point where you aren't willing to give back to where the Stop needs to be, then close it out and wait for the next trade.

How about exits? Well, IMO S/R levels are the only way but opinions vary, and differ. You could wait for it to test an area that you don't believe it can get through the first time such as a major or Key S/R level (however you determine them). You could also wait for it to set up against you and then exit. You could use certain candlestick patterns. Or once you develop some really good skills you'll be able to see changes in the character of the price action that will aid in the decision making. Regardless of how you choose to do it, sometimes you're going to look like a genius and other times you're going to look like a doofus as you will soon see in my examples.

To summarize, start with the "free trade" method and use this until you get comfortable being in a trade, know how you react under different pressure situations and have an overall sense of confidence. Then introduce the All in/All out via trail and once you get comfy here you can bring add-ons into the fray. For me, unless I'm fooling around inside a range I almost always use the all-in/all-out with add-ons approach because I think it's much easier and more productive. Now I know some of you who measure their trade time in seconds are saying "no bleepin way" that's easier! And to that I have three things to say. First, I used to feel exactly the same way. Second, you're wrong. And third, if you don't learn how to trade then you will be limiting yourself to being a scalper and/or consistently inconsistent.

Lets look at a few trades from this week starting with 4/28. I'm going to use TF because almost everyone trades the stock indexes - not because I think they are the best market or even a good market. More on that later.

I always find it helpful to see what the longer term charts are doing before the day begins so let's do that first. The daily chart shows a clear uptrend that has stalled out in the 480 area which was the scene of a double top back in late Jan/early Feb. The 120 minute chart shows a clear range and compression inside the range with a close in the upper part of the range. If 465ish remains support you would expect another run at the top of the range which is a Key S/R level. If 465 breaks then you would expect a test of 456/449.





Whether one, none or both of these scenarios occur is immaterial because Price is going to determine what trades are taken & when (no opinion necessary). We just want to know what each side has to do to get a move going and then what lies ahead. Onto 4/28 which turned out to be a well behaved market. The first chart shows trades taken, the 2nd tries to draw attention to setups/structure & S/R levels behind the decisions.



OK, let's look at one more day and it probably makes the most sense to use the following day, 4-29. Like before let's start by taking a look at what we knew going into the day.



While 4-28 was a very nice day to trade with an orderly market and a wide range, nothing really happened. We're still range bound, we're still compressing against the top of the range and we closed again in the upper end of the range. And we still know that if the top of the range breaks we should get a runner. So let's see what happened.



The day began with a fairly large gap up, traded sideways for a bit, moved higher and to within a point of our 482ish, retraced and then held the early highs as support. This was a **very** promising set of events and unlike the day before it didn't disappoint. It broke through 482 easily and didn't take a breather until 487, and even that flag wasn't much of a breather as it only retraced 2 points before taking off again. It was however a very nice setup if you were looking to enter or add-on.

From there we basically went into FOMC mode with a 100-minute long flag and one last little pop before the "news". There was one short trade late in the day that ended up a scratch. And I had one doink playing around after the news but I didn't put that on the chart because it was basically a flyer that had no setup.....I had a 499-500 test in mind if/when we broke out of the range and I thought we might get that after the FOMC. I was wrong. But overall a good ½ day which is typical of FOMC days.

The above examples were intended to provide more of an overview of the whole process, but now I'd like to try another approach by starting with the trade/setup and looking at longer term charts as needed. And we're going to start with the TF chart of 9/16 because it has a lot of interesting components even though the indexes were the least exciting market this past week.



The market had a pretty good day on 9/15 and opened higher on 9/16. It then spent the first hour in a 3 point range before giving the first sign of a decent setup. After it made the higher low I decided to try a buy into the top of the range @606.60 (blue line) with a Stop below the HL. Let's see what happens next.



The buy triggered, broke through the top of the range and is now trying to consolidate that gain. So far so good, and if/when it makes new highs we can move the Stop under the last support area which is the upper white line.

I'm also going to add-on to this trade @608.70 because this is a nice looking res:sup flag at what should be the early part of a move.

But wait, haven't we forgot something? How about what S/R levels lie ahead especially if we're looking to scale out? Well, the Stop on this trade was about 2 points and the market advanced past our entry by 2.3 points so you had a chance to take a partial and bring the trade to b/e already. And you could move the stop up about a point to under the little HL that formed right before it broke out of the range (the bar before we were filled). So if you're scaling you've got a gain locked. But I wasn't and wanted to know where the next key hurdles were so let's try and find them by looking at the longer term charts.

Here's how 60-minute looked after the first two hours of trading:



No help here in terms of Resistance levels. How about a daily?



The daily going back to early June is no help either, so let's go back further to the last time the market traded at these levels.



Well, the last time we were at these levels was in October of 2008 and there isn't much data to work with on this contract. But it looks like we're inside a gap between the close of 620.30 on 10/3 and the open of 598 on 10/6. The 10/3 close could be useful but is there another way to get a better picture? If this was another futures market, maybe not, but we can use IWM in this case so let's take a look.



We are inside a gap and a large one of 20+ points. So this provides some clarity but nothing in terms of R levels until the 620 area. This isn't really a problem though because we're going to let the trade play out and wait for the market to tell us it's over anyway.



Last look at the 5-min had us in the 609 area looking to add-on and now we've moved up to the 612.50 area. Plus we've been allowed to move the Stop up several times to just under 611 so both trades are locked. And up until now there hasn't been a single down bar that was in the least bit troubling. But we have one now as I've tried to note by the red line.



25 minutes later and a LH formed so this trade is looking like it's going to end shortly.



And end it did but as we'll see in a few minutes it was just a little shakeout move.



Getting shaken out on this shallow a retracement is a bit embarrassing (and annoying) for me, but I followed the rules and it's time for the next one - which looks like it's coming right up. You can see the little head fake through 611 that took me out, then the immediate reject back above 611 and then it held 611 as support so I figured I got hoodwinked. And I was looking to reenter through 612 with a stop below the head fake low @610.70.



This trade started out great then petered out for a marginal gain and that was pretty much the end of the activity for the day. Not a bad one with 2 wins and a scratch but not exactly an exciting market. Fortunately there were other markets that proved more entertaining.

I'm going to mark up two more charts and then close up shop. On these a blue/red "+" sign indicates the entry bar and the little blue/red lines indicate exit points.



This was 9/17. A not-so-great chart that produced 1 nice win, 1 small win and a couple of scratches/small losers. But remember all the work we went through to find R levels awhile back? And remember the gap at 620.30? **Note the high of the day @620.50.** And note the rejection off that level. Probably just a coincidence....



And this was expiration Friday which is usually a yawner. But this one was a little better than normal yielding two decent winners.

Conclusion

Well, this project has gotten a bit more involved than I planned and there's still a ton of stuff I could add. But I couldn't see any way to talk about Price Action without also showing how the pieces fit together. And I haven't left anything out that will prevent you from figuring it out on your own if you put forth the effort. Anyway, I need to wrap this up so let's close it out by revisiting the S/R-Price concept.

If what I've talked about so far makes sense and you're interested in learning more about it, then there's only one way it's ever going to happen and that's to study **thousands** of charts over an extended period of time (months/years). Hence the purpose of this mini lesson which is to provide you with a framework so you can spend that time studying at least some of the right stuff. Of course you could always do it the way I did which was from scratch with no help and without a clue.

So what/how to study? Easy - any market on any timeframe on any type of Price chart. Study what a market did while it was compressing/range bound. Then study what it did when it broke out of the range. Then study what it did while it was trending/moving directionally. Then study each retracement. Then study what it did when the move ended. And look for your setups but remember some moves will not setup so be happy with being able to capture the middle 2/3 of 80% of them.

And when you're studying these charts make sure you **wear out the horizontal line tool** because that will naturally draw your attention to the left side of the screen and help you see the S/R lines, structures, etc.

If you invest the time you will eventually start seeing (and understanding) S/R lines, structures, and setups along with developing an overall sense that you know what a market is doing at any given time **and what it has to do to put you in a trade.** You'll also discover what you're good at & what you like, and what you don't like (when to stay flat) which is just as important as knowing when to trade. And a good example of this would have been Friday (5/1) which had a 9 point range (TF) and some of the most vulgar price action you'll see.

A couple final thoughts - the losing involved in the learning process conditions us to view a Stop as a Loss when it's really just a tool to preserve capital/profits. As a result people tend to become fixated (obsessed) on the risk of a trade/setup (usually ignoring everything else) and make that the deciding factor instead of the overall risk/reward.

For example, for the 5 trades discussed on 4/28 there was a total of about 12 points per contract put at risk (a little less per contract on 4/29) but I know that some are looking at those and thinking the risk is "too much" for one trade. Then they'll turn around and during a lesser period of time take 12 scalps risking 1 point per contract trying for a 1 point gain on each. All I can say is that it might make sense to revisit the math because in my view the 12 scalps have more overall risk and considerably less reward.

Try to trade only what you **see** and not what you think. Do whatever it takes to learn how to wait for the market to tell you what to do. And lastly - please, please look at other markets besides the indexes because there are much better markets to trade such as Bund-Stoxx-Euro-BP-Gold-QM-Beans-Corn-Bonds-Notes, etc. Plus the indexes IMO are the most difficult market to learn how to trade on.

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