Tips for Traders | 10/19/2007

Profits: Getting the Most Out of a Vertical Market

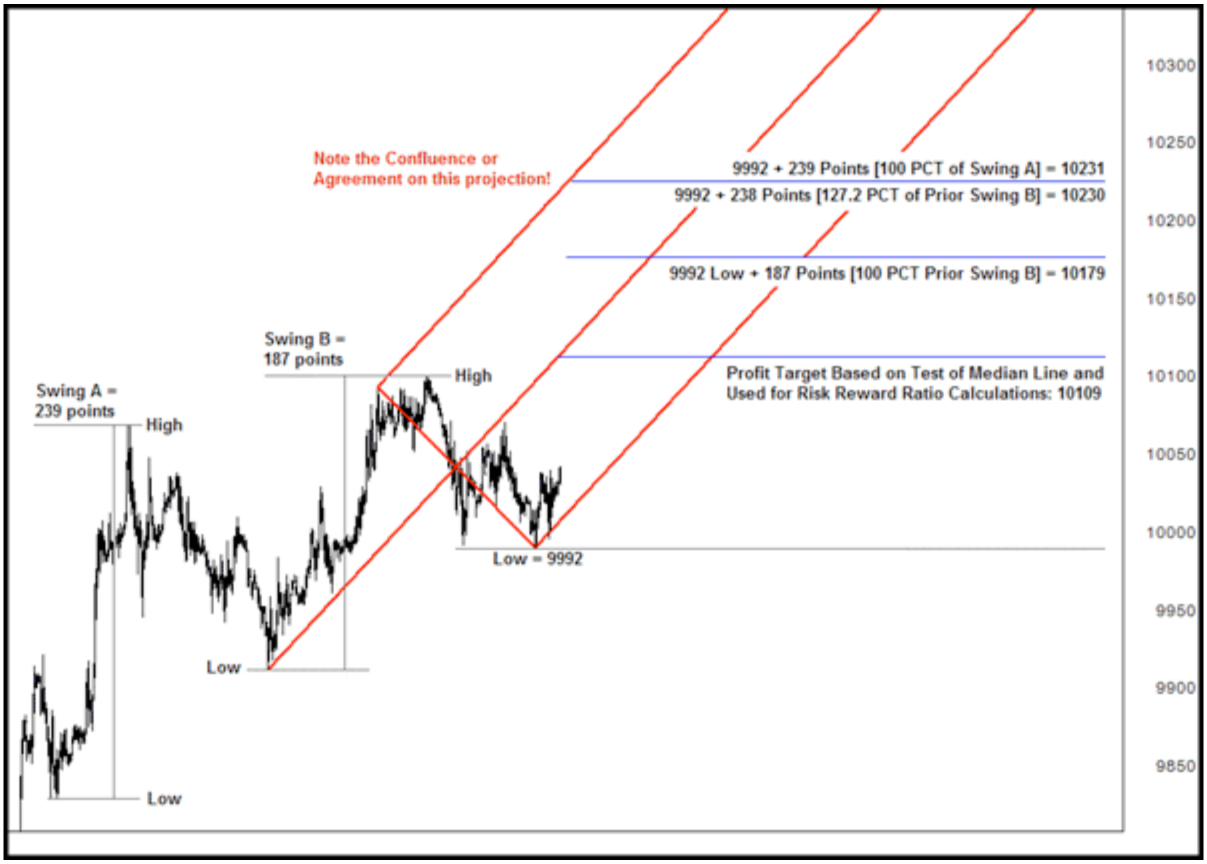
If you spend any time at all looking at commodity or stock charts, you'll see times when the market is moving 'normally' and then suddenly takes off, moving in a near-vertical fashion. Most of the time, these moves come on news and are unpredictable—the best you can do is hope you have a position in the right direction and let the wild ride hit your profit target. And then enjoy the feeling of making a nice profit, of course. Unless your trading plan and thoughts contained a sense that a major movement was about to take place, any thoughts about capturing large portions of these vertical movements are a waste of time and energy and emotions.

But what if you were stalking a trade in a very strongly-trending market and you were lucky enough to find a high probability entry on a pull back, knowing the ride might get wild and the move had the potential to be vertical? Are there ways in these abnormal markets to project where these vertical movements are likely headed?

Let me pause here and state for the record that the majority of my money is made trading in calm, normal market conditions. And one thing I always tell the traders in my seminars is that traders that spend time and money trying to buy bottoms and sell tops generally don't make it. To paraphrase JP Morgan, 'I've made a fortune taking my profits early and leaving large portions of a move on the table.' I always have my stop loss order, my entry order and my profit order ready before I enter a trade. And more than 90 percent of the time, my trades are made in normal market conditions and my profit orders are set up to take advantage of normal market conditions. Do I miss vertical moves at times? I certainly do! But you can bet I never lose a wink of sleep worrying about leaving money on the table. I always have a plan and I always trade my plan.

My two 'bread and butter' profit methods are taking profits at: 1) the intersection of price with an Andrews Median Line or one of its parallel lines and 2) measuring the size of the prior major swing in the same direction and then setting my profit at or near 100 percent of that prior move added onto the low of the current swing. I've shown these two profit techniques hundreds of times in my articles and Webcasts and those of you that have taken my seminars or belong to my free trading forum know that I use these two profit techniques over and over again. If I leave money on the table, it doesn't bother me a bit, as long as I executed my trade plan.

There are times, however, when I look at a chart and my intuition tells me the market has the potential for a 'wild ride' if it will just let me in before it takes off. And I'll note that in my pre-trade plan as I work out my orders, because there are ways to capture these vertical moves if you anticipate them, have the right position and then the moves materialize. Here are two very easy ways to project forward potential profit targets if the market 'gets wild' and goes vertical: 1) go back to the prior swing and use a simple but seldom used Fibonacci projection ratio that seems to do a great job projecting where price should run out of directional energy in these vertical markets. It's not difficult and I didn't invent it—here we go: take the prior swing and multiply it by 1.272 and that's often a very good projection of where price may be heading, 2) Take into consideration the size of the past few swings in the same direction when determining where price may run out of directional energy. For examples, go back two prior swings and find out how large that swing was. Then project 100 percent of the size of that swing from the low of the current low. And this is most important: when you see two or more projections working with different swings that are at about the same price, pay attention! I you do manage to enter the market and if it does 'go vertical', if it gets anywhere near a set of projections from different prior swings that are confluent [or match], make sure you have locked in your windfall profits before price hits these confluent projections. Let's see if a chart makes this clearer:



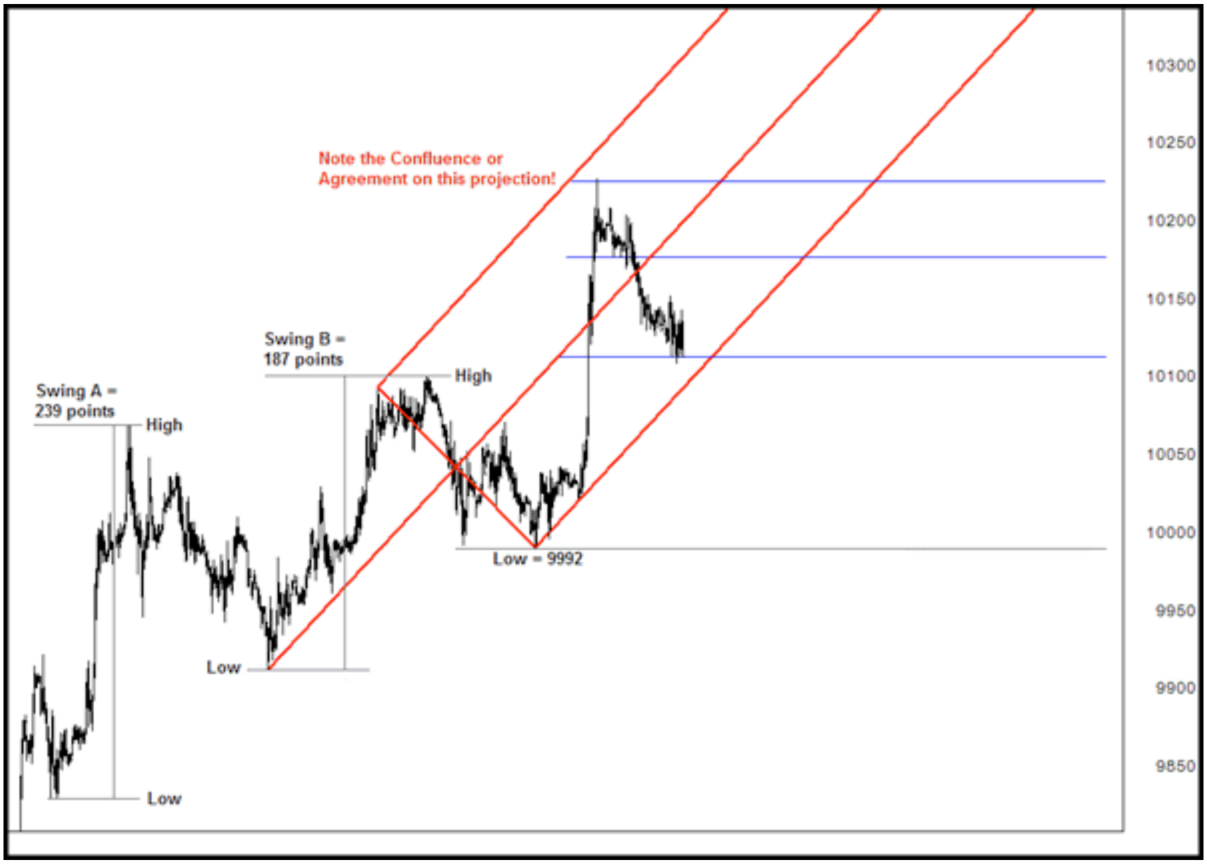
In the chart above, I managed to get long at a test and re-test when price pulled back to the red Lower Median Line Parallel. That's the end of the discussion of the actual trade for this article. I managed to get long with an acceptable stop order and now let's focus on several potential profit order areas.

I noted in my trade plan that this market had been in a very strong trend and had the potential for explosive up side movements if I managed to identify a high probability entry and if the market let me in. My 'normal' profit target is the first one marked on the chart, a test of the up sloping Median Line, and at the time I entered the market, price would have intersected with this Median Line at 10109. I use this first 'conservative' profit target to get my risk reward ratio because the Median Line theory says a test of the up sloping Median Line may be all I get out of this market to the up side. If price makes it to this first profit target, my risk reward will be over 6:1 on this trade, so it is more than acceptable. But what if my intuition is correct and this market experiences an explosive upside move? What other profit targets might I use?

The second profit target is a simple calculation of the low of the current swing plus 100 percent of the size of the prior swing in the same direction, which happened to be 187 points. If I add 187 to the current swing low of 9992, I get a price of 10179, which would be another very good area to consider taking profits. These 100 percent swing targets can be very accurate and very few traders use these simple swing targets.

The last of the targets is an area of confluence or agreement between two mathematical calculations done on the two prior swings. To get the first of these pair of projections, I took 100 percent of the size of swing 'A' [two swings in the same direction back] and added it to the low of the current swing. The size of that swing was 238 points, so when added to the current swing low of 9992, the potential profit target would be 10230. To get the second of the pair, I took the size of the prior swing and multiplied by a very effective Fibonacci projection ratio, 1.272 and then added the result to current swing low. The size of the prior swing was 187 points and when multiplied by 1.272, I get a value of 239 points; when added to the current swing low of 9992, it gives me a potential profit target of 10231. Because these two match so close, if price gets near this area, I'll be out of my position. In fact, I put in orders to exit my position using a limit sell order at 10223.

If you have seen any of my Webcasts, articles or read one of my books, you know I always box in profits underneath market formations, so if the market leaves formations, I'll snug my stops as price advances, even though I have a feeling this market has the potential for an explosive upside movement. But one thing to remember about explosive movements: they seldom leave market formations—hence the term ‘vertical moves’. That’s why these techniques for projecting alternate profit targets can really improve your profitability when you catch a few of these wild rides. Let’s see how the market unfolded and which of these profit targets proved most useful:



As you can see, all three profit targets were met. Before you jump to the conclusion that the third method using the confluence of two swing projections gave the ‘best’ profit target, remember that’s only the case if you had this as part of your trading plan before entering the trade. There would be nothing wrong with taking your profit at any of these areas. All three of them are excellent high probability profit targets when used correctly. In the case of the first profit target, as time moved price to the right on the chart, remember that it is based on an up sloping line, so I would have been constantly monitoring where price would intersect with the up sloping Median Line and moving the limit sell order higher. And in fact, price intersected with the Median Line at 10139, so it captured a very nice profit. Both of the other two profit targets were higher and caught more of the move, but remember they caught the extra profits because this was an unusual market. Setting realistic profit targets is more important to me than trying to maximize profits on each and every trade. I chose the highest set of profit targets in this trade because my intuition after reading the chart told me an unusual explosive move might happen—so I prepared for an unusual event. If I had a choice between catching the extra profits on these explosive moves or doing a better job on setting realistic profit targets within ‘normal’ market moves, I’d work on improving my realistic profit target placement! But if you are looking to take more of the profits out of these explosive moves, give these two measuring methods a try.

I wish you all good trading!

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