

Tips for Traders | 8/7/2007

Don't Forget to Pack All Your Tools!

I still remember my father telling me, "You can't use a wrench if you left it at home, son. Always bring all your tools with you when you go to a job." My father was a welder. I'm a professional trader. But bringing all your tools to the job at hand is just as important to me, and all traders, as it was to my father.

But when I say "bring all of your tools," I don't mean throw every new multi-derived curve fit oscillator whizz-bang on a chart when you're ready to trade. I mean the tools you are familiar with, the tools you have mastered. And tools you may not think of as tools, like solid money management, risk reward ratios and simple profit target projection tricks that help you lock in profits. Sometimes the best tools are sitting between your ears—if you remember to pack them and then when the time is right, take them out and use them!

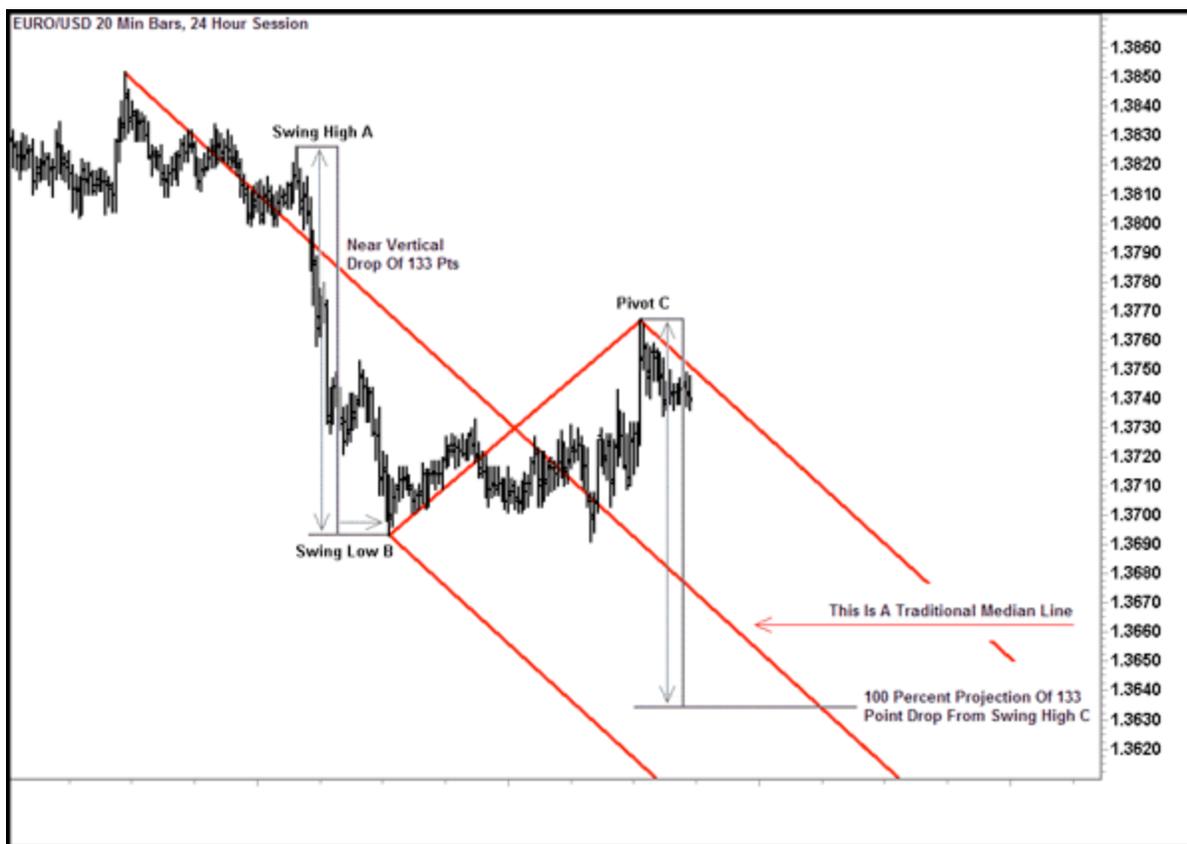
Probably the most active market is the cash foreign exchange market. The total amount of currencies traded every day dwarfs the value of all the stocks traded in one day, all the options traded in one day and all the futures traded in one day. In fact, it's currently officially estimated that the cash volume being traded in foreign currencies worldwide is more than 10 times as much as the total cash volume being traded in all equities [stocks and options] worldwide! Currencies start trading on Sunday afternoon in the United States and trade continuously until late Friday afternoon. And because any time money flows from one country to another, currencies are traded—so there are plenty of opportunities to take advantage all the time in the currency markets.

Let's take a look at one of the most active currency pairs: The Euro versus the US Dollar. I'll be looking at simple 20 minute charts that cover the entire 24 hour day. The Euro had been gaining in value against the US Dollar all summer long and then in late July, a sharp sell off began. After several days of sharp losses, the Euro began to regain some ground on the US Dollar. Let's take a look at a chart of that action now:



The Euro/USD has been in a nice down trend. After a near vertical fall of 133 pips, price has congested a bit, re-tested the low price made during the recent fall and has now begun to make higher highs and higher lows as it heads a bit higher.

I added a red down sloping traditional Median Line drawn from the high of this most recent move down using the latest swing high as Pivot C. This should give me a good feel for the direction of this market. The Median Line is a line of force and it projects forward in time and space the rate of rise or fall of price and the likely path price should oscillate around--In other words, it should show me where price should run out of up side directional energy and down side directional energy: at the Upper and Lower Median Line Parallels.



Now here is a simple yet powerful tool from my toolbox and yet, most traders never bother to use it. A wise and very experienced trader once told me that if people would only look at the projection of equal movements, they wouldn't need any other measuring tool when it comes to price projection targets. By this, he meant simply measure how far price moved on one major leg and when the next major leg begins, measure the same amount and expect that price will make it that far--and if you have the right position, take your money and run! Nothing fancy about this, but it is deadly accurate! In simple terms: The distance from A to B will then equal the distance from D to E. Can it go further? Yes. Can it fall short? Yes. But with solid money management, if you capture these equal movements on a regular basis, you will be taking the 'meat' out of a majority of the large moves 80 percent of the time.

Note that price has NOT moved above the Upper Median Line Parallel, so I am still bearish on this market. It would take several closes with quality separation above the Upper Median Line Parallel for me to consider becoming a buyer.

I simply measured the distance from the last high before the vertical drop began to the low made before price began its consolidation [that was 133 pips] and then went over to the last Swing High "C" and projected that same distance below Pivot C to give me the most logical place price would head to with the highest probability. This is a simple but effective tool. Using the simple assumption that the near vertical fall from Swing A to Swing B was 133 pips and moving over to the current high I am assuming is going to develop into Swing High C, I get a potential downside movement to the 136.35 area. Since price is currently trading near what I consider to be overhead resistance at the 137.50 level there is plenty of room below to capture a very significant profit if I can find a repeatable trade entry to establish a short position with good risk reward and solid money management.

Now let me introduce another charting tool I find extremely useful:



There is a special consideration here: Price made a near vertical fall and that often gives any and all indicators and lines fits, because it 'skews' the scale of the rest of the price action. Simply said, the vertical fall was abnormally large ranged bars with abnormally large volatility and the bars following the fall are of normal range, with normal volatility. Using abnormal ranges or volatilities and then projecting forward mathematical relationships onto markets that are trading with normal ranges and volatilities generally degrade the precision of your mathematical projections. Again, stated simply, if you use a yardstick to measure the size of a grain of sand, the measurement won't be very accurate.

You can see I added another type of Median Line, one that uses an "A" Pivot shifted from its original position to 1/2 between the high price at Swing High "A" and the Swing Low "B" and also 1/2 between the 'space' measured from Pivot "A" and Pivot "B".

This type of Median Line is named an Schiff Median Line and was developed by Jerome Schiff, a New York based trader that was well known around the kitchen table at Dr. Andrews' home in South Miami. Schiff always wondered if there was a way to know, after a near-vertical move in stocks, when the large one-way move was over. And in his research, he came back to Dr. Andrews with a new type of Median Line that was 'shifted' in a similar fashion to what I have drawn here. His contention was that once price made a vertical down move, if price then climbed back above and made several daily closes above the down sloping Upper Median Line Parallel, it was time to begin to look for trade set ups to get long. After reviewing his research, Dr. Andrews made a few minor tweaks and thus the Schiff Median Line was born [in Andrews' 'Action-Reaction Course', it is referred to as the modified Schiff Median Line, because there are still uses for the Median Line Schiff originally presented to Andrews].

Why did I draw this Schiff Median Line? From all the years of experience I have, I know that the vertical move has skewed the relationship between the obvious alternating pivots I am likely to choose when drawing a Median Line that a Schiff Median Line will most likely give me a better indication of the boundaries of where price will run out of up side and down side directional energy--and that's what I need to know to initiate trades!



Price consolidates in a classic Energy Coil as it re-stores the energy it expended making the vertical drop and then slowly climbing out of the hole. Energy Coils and Energy Points generally turn out to be areas where market moves begin or accelerate. The trick, of course, is identifying which direction the market is going to take and then find a repeatable entry pattern to enter with solid money management.

One of my 'bread and butter' entry set-ups is one I call 'test and re-test'. And by this, I mean that once I draw in a Median Line or Trend Line, I want to see price test that line and if it fails to break above a down sloping line, for example, I will then sell the next re-test of that down sloping line if I like the risk reward and money management of the potential trade.

In this chart, you see the 'test' of the red down sloping Upper Median Line Parallel [and remember this is a Schiff Median Line, so even though price had a vertical drop of abnormal volatility, I expect this Schiff Median Line and its parallels to contain price unless the trend changes.

After the 'test' bar, price trades and closes right back within the Energy Coil. I have a short bias in this market, I have now seen the 'test' of the Upper Median Line Parallel, now let me see if I can diagram out a potential trade set up:



Now that I have seen the 'test' of the Upper Median Line Parallel, I'm going to try to use one of my favorite trade entry set ups, the 'test and re-test', to enter this market. I want to sell a retest of the red down sloping Upper Median Line Parallel. To find where price would intersect with this down sloping line, I simply run my cursor over the line one or two bars worth of space to the right of where the current bar is unfolding. That gives me my potential entry price. I could place my entry order slightly below this line, as an aggressive entry, but I find that I like it better when I let the market 'stretch' to re-test the line--and it also makes my initial stop loss entry as small as possible. So I want to sell the EURO/USD at 1.3753 limits.

Now, what about the initial stop loss order? I could simply place a ten-tick initial stop loss order above my entry price, which would give me an initial stop loss order at 1.3763. But looking at the chart, I notice that there are a series of lower highs to the left of the Energy Coil that are right at and slightly above that price. These tops should act as resistance. And of course, it would be even better if I could hide my initial stop loss above Swing High C, because there should be even more sellers just before and at the Swing High.

If I am right about the potential magnitude of the drop that this price should give me [133 pips], I am more than willing to use what I consider to be wider than normal initial stops. I know this market has had some large range bars and I want to be careful that I don't miss this down move because I used too small an initial stop order. I place my initial stop loss order at 1.3775, 20 pips above the price spike that 'tested' the red down sloping Upper Median Line.

And my profit target? I've already done the math for you: I measure 133 pips down from Swing High C and that gives me a logical profit target of 1.3638. If I can take 120 pips out of this market, I'll take my money and run!

This set of orders means I am risking 22 pips to make 120 pips, which is a risk reward ratio of about 5 1/2:1. What about the size of my stop? It's a bit pricey relative to my normal 10-15 pips, but because I perceive this as a very strong down trend and also have what I consider to be a very high probability profit target that gives me such a large potential risk reward ratio that I am willing to accept the size of this stop order.



Well, sometimes price just doesn't cooperate--at least immediately. You can see that price continues to trade within the narrow Energy Coil and has not yet come back to re-test the red down sloping Upper Median Line. And so I am not yet short this market.

Also note that as price consolidates underneath a down sloping line, the re-test area will be lower as time [or space] continues to move forward, so as each bar finishes, I run my cursor over where price would intersect with the red down sloping Upper Median Line Parallel to find where my sell order should be placed. As the intersection changes, I cancel and replace my order. Note that there may be a price where the stop becomes too expensive! Currently, I am working a sell order at 1.3748 and my initial stop loss order remains the same: 1.3775. That means I am now risking 27 pips [an additional 5 pips from my first limit sell order price] and my risk reward ratio is right around 5:1, so it has come down some but it is still a very good risk reward ratio.

I am near the point where I will not be willing to take this trade because of the size of the initial stop--But note that if price continues to trade within this Energy Coil much longer, it will have drifted out of the Upper Median Line Parallel to the right, and I'll then no longer be interested in getting short. It's 'now or never' for this trade set up!



Two bars later, price does indeed test the red down sloping Upper Median Line, getting me short at 1.3748. The bar closes back within the Energy Coil with nice down side separation but because price is now so close to the Upper Median Line, price needs to begin a down move soon or I am in danger of price 'drifting' outside and above this down sloping Upper Schiff Median Line and that would change my view of this entire trade set up.

Once I see my sell entry price print, I check the audit trail on my electronic trading platform to be certain I am filled. Then I double-check that my initial stop loss at 1.3775 is working and in the market. Once I check those, I enter my limit buy order at 1.3638, my profit target. And I make this order contingent or 'OCO' with my stop loss order, so that if one order is filled, the other will automatically be cancelled.

To summarize, I showed you a high probability entry method that you should be able to spot over and over again in any market, on any time frame, the 'test and re-test' entry. If you couple this high probability trade entry set up with solid money management, you should be on your way to profitable trading if you are an inexperienced trader. And if you are an experienced trader that relies on simple break out or un-filtered support and resistance entry methods, the addition of this entry technique should improve dramatically your profitable winning percentages.

I then showed you how I use rigid money management and risk reward ratios when preparing for a trade. I showed you in detail where I would be willing to enter a short position in this market and what initial stop loss and profit target orders I would use—and more important, why I chose those levels.

Finally, I showed you the execution of my limit sell entry order as price re-tested the red down sloping Upper Median Line Parallel. After I checked that I was filled on my entry order, I checked that my initial stop loss order was in the market and being worked. And then I entered my limit buy profit order and made it contingent with my initial stop loss order.

Here's the status of this trade as Part III of the article begins:

1. I am short this cash EUR/US at 1.3748
2. My initial stop loss order is at 1.3775
3. My profit target is at 1.3638

Now that I am short, let's see what this market does!



A good portion of the energy price re-stored while trading in that narrow Energy Coil is now being spent with a violent thrust lower as price moves away from the down sloping red Upper Median Line Parallel. After price spikes lower the first time, it leaves a spike higher and when price then makes a new low for this move away from the Upper Median Line Parallel, a new Swing High is formed at 1.3734. I cancel my initial stop loss order and place my stop profit order 5 pips above this new swing high at 1.3739.

I am now playing with the market's money, which is always a good thing. Now it's simply a matter of trade management: Boxing in profits until either my stop profit is hit or my profit target is hit.



After the two large spikes lower, price is low on energy, so it forms a classic area of congestion. Price is re-storing the energy it spent pushing lower, taking a breather until the next move unfolds. I expect price will continue lower and it does, forming quite a large spike lower that closes well below the red down sloping Schiff Median Line. I now move my stop profit order to 5 pips above the 1.3711 top of the congestion area, at 1.3716. I would move my stop order closer but there is no price formation to hide behind!



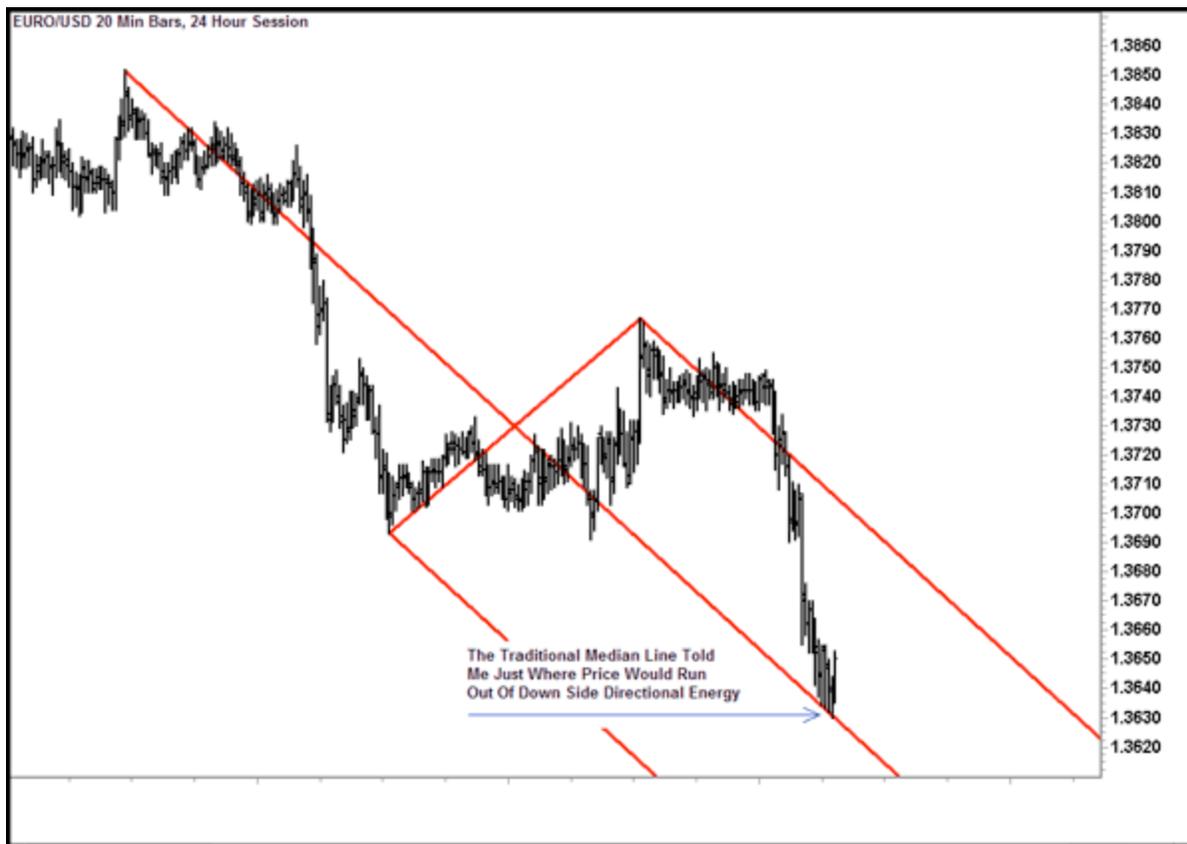
Now that price has firmly established itself below the red down sloping Schiff Median Line, it begins to make a series of 'same size bars'. And note that third and fourth bar following the large range 'zoom' bar have smaller ranges and are what I call 'mirror bars', which means they have the same range and have alternating closes: The first mirror bar closes higher than the bar before it and the second mirror bar closes lower than the first mirror bar. I have found these bars to be great markers for me: When I see mirror bars form, I always re-assess my outstanding risk on any open position. In this case, I decide to snug my profit stop to six pips above the 1.3675 double tops of the mirror bars, to 1.3681. Why six? I prefer 1.3681 to 1.3680--but its only personal preference. I have no statistical studies showing me that one pip will give me an edge--but it makes me feel better, so I'll spend the extra one pip.

You can see price is very close to hitting my profit target and in many cases, if I was short against down sloping lines, I would be moving my profit target down to match the slope of the Lower Median Line Parallel. But in this case, the profit area was not based on this down sloping Lower Median Line Parallel but instead was based on a simple 1:1 measurement of swing lengths. I am going to keep my profit target at 1.3638 and I'll be very happy if it is hit.



Price continues lower, making orderly lower lows and lower highs until it hits my profit order level at 1.3638. When I see my price print, I check to see that my electronic platform says I am filled, and then I make sure there are no outstanding orders. I double-check that I sold and bought an equal amount of contracts [or currency in this case] and that I am flat and working no orders. Finally, I do the math and make certain the P&L looks right—now is the time to uncover an error, not when I get my statements the next morning! Everything looks good, I'm working nothing and I can take a breath and enjoy a nice profitable trade in the EURO/USD that netted me 110 pips, or roughly \$1500 per \$100,000 traded [roughly the size of a CME futures contract].

Before I close the book on this trade, let me point one last trick [or tool] out to you: Look at the next chart and see where the traditional Median Line predicted price would run out of down side Energy!



Did I look at the traditional Median Line's projection when choosing a profit target and when choosing not to lower my profit target as price approached my 1.3638 limits buy order? Of course I did! Always use all the tools available to you when making decisions.

I wish you all good trading!

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