

Tips for Traders | 7/13/2009 10:05:00 AM

## **How One Repeating Pattern Makes for Consistent Trading Profits**

The market trends and then the market moves into a trading range, resting before moving back into a trending state. It's easy for some traders to trade a trend, for other traders to trade a range, and some are even gifted enough to successfully trade both trending and ranging markets. And it is generally easy to spot the transition from a trending market into a range-trading market, and similarly, from a range-trading market to a trending market.

But most traders are frustrated when a down-trending market changes directions and then begins trending higher (the same being true when an up-trending market changes direction and begins trading lower). The abrupt turns are hard to spot, and most traders just don't know how to deal with these changes, or haven't found rhyme or reason behind them and end up scratching their head as the new trend unfolds in front of them, leaving them behind without a position.

During the crazy, dot.com stock market rally of 1999 to 2002, I made a huge amount of money trading the Nasdaq 100 futures because their intraday trends were easy to spot and their daily ranges were often 200-250 points! The money was easy, and believe me, I milked every cent out of that market until the dot.com bubble burst and the Nasdaq 100 futures daily range eroded to well under 30 points a day.

I had one rule that always served me well back then when I traded the stock index futures so actively (and in fact, I still observe this rule religiously today): The cash market in stocks open at 8:30 am CST and it takes a good 45 minutes to an hour for the larger cash portfolio traders and cash specialists to get their "books" in order. I call this the "push and shove" hour, and although I know many traders make a lot of money in the first hour of trading, especially those that can take advantage of these imbalances, I know my strengths and weaknesses, and learned early on that my monthly profits increased significantly if I waited until after that first 45 minutes to consider trades in the stock index futures. So I had a "dead period" between 8:30 am and 9:30 am each morning, and in fact, because there was so much volatility in the stock index futures, the currency trends were relatively tame during that period as well. I soon realized that the first two hours in my trading day—from 7:30 to 9:30 CST—held a smaller profit potential than the rest of the trading day. So should I just start trading later and sleep in, or perhaps just accept much smaller profits and trade during those first few hours to tune up my intraday trading?

Before deciding to just sleep in for those two first hours each morning, I decided to do some intense research. My trading is built upon two things:

1. Trading repeatable patterns I can see and trade consistently, and...
2. Using surgeon-like money management to control my risk.

I decided to take these two strengths and look through the available markets to see if I could find something that fit my needs and would be effective during those first two hours (remember, at that time, I didn't need more risk after 9:30 am!) I was looking for an early-morning pattern in a market that was liquid and trading actively between 7:30 am and 9:30 CST each day.

Of course, the answer was right in front of my face, since I live in Chicago, home to the largest futures exchanges, but until I began this research, this particular market had always been an afterthought in my mind. The US 30-year bond futures, traded at the Chicago Board of Trade, were (and still are) incredibly liquid. Once

I began looking at them and researching for a repeatable pattern, I was surprised that I had been ignoring them. I can only say, in my defense, that as a chartist, the average ten- to 20-tick ranges available to trade during the first few hours looked rather small until I realized that each tick was worth \$31.25! If I could find a repeatable pattern that captured eight ticks consistently, it would equal \$250 a contract, or be the same as catching a five-point move in the e-mini S&Ps! What at first seemed like small ranges began to have an appeal. Now, would I be able to find a repeatable pattern that I could see on a regular basis and trade consistently, and one that appeared regularly in those first few hours of trading?

There are many ways to do research to identify patterns hidden within charts. I do have proprietary database programs that search for specific patterns and I have spent a great deal of money over the years developing these programs as computing power has grown cheaper and much more powerful, but to be honest, I still find my eyes are my best research asset. I have been charting commodities, currencies, and futures for more than 38 years, first exclusively by hand, and now using a mix of hand charting on paper and computer charting programs, and my eyes see things that would be very difficult for me to translate into computer language when I am first searching for a repeatable pattern. Once I have found a repeatable pattern, I am generally able to describe it in mathematical terms and have it entered into a database program that keeps track of the new pattern and its statistics. But when it comes to finding new, repeatable patterns that work, I still find my eyes are my best tools.

I literally printed out thousands of charts of the bond futures of various time frames, focusing on those first few hours, and then spent quite a few weekends going over those charts by hand, using my eyes to search for a pattern I could recognize and then doing statistics on a few candidates to find one that indeed was repeatable, reliable, and seemed to be consistently tradable.

But once I thought I had found one (I actually found three), the work hadn't ended. Would I be able to see the pattern in real time and would it play out and be tradable as it unfolded in real time on a consistent basis? Two out of the three candidates I identified were not consistently obvious to my eyes as they unfolded in real time, but one caught my eyes immediately as I watched the bond futures trade in real time, between 7:30 and 9:30 each morning for the first few months. You read that right—after all the research, after finally identifying what I was sure was a new pattern I could see consistently, I watched this pattern in real time for two more months before beginning to trade it with real money.

One last note before we begin looking at this pattern in detail. The markets constantly evolve and change, and after about three years of using this pattern regularly, I began to see it less and less. The currencies had come alive, the range of the Nasdaq futures had shrunk to an average of about 20 points a day, and the bond market changed behavior as well. Traders who don't adapt when the market changes its behavior become losing traders. When I began seeing this pattern less and less, I shifted my focus to other repeatable entries I had identified and this particular entry was put on the back burner.

But in the past six to nine months, I began to see this pattern appear more and more often as the bond market began to expand its ranges, and now I trade this pattern again on a regular basis.

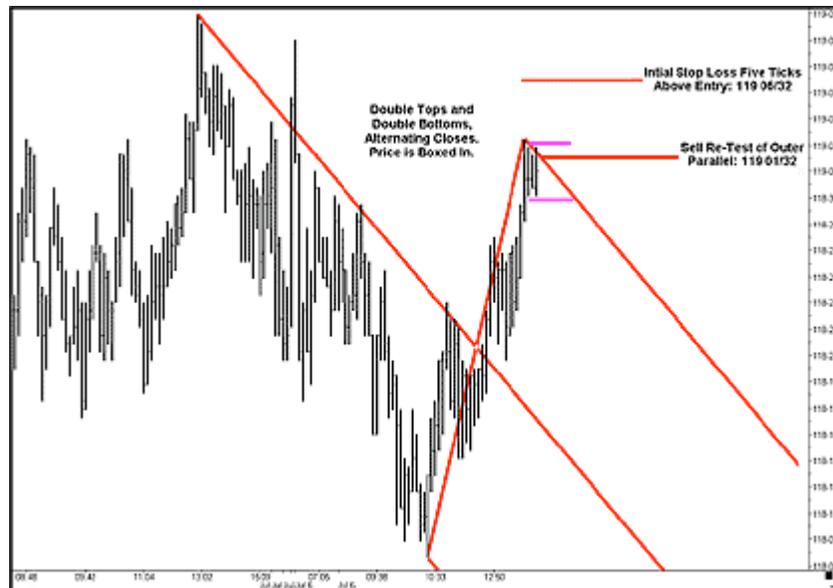
Let's take a look at the pattern, which I call a "Corner Trade." For the most part, I only use it to trade bond futures (if you trade ten-year bond futures, it is equally applicable), but I am seeing this same pattern, albeit with a slight twist, appearing now in other markets, but we'll leave that for another article!



Here's a recent chart of the US bond futures. It is a tick-based chart, not a time-based chart, which means that I have taken time out of the equation, and as a result, price does not drift to the right when there is no activity in the bond futures.

Price made a nice move down, with easily identifiable swing highs and lows, then turned higher with no warning and left easily identifiable swing highs and lows as it moved to the upside as well.

See how price boxed itself in, leaving double tops and double bottoms as it congested in a very narrow range, relative to the size of the prior swings. Note that the pattern does not require double tops and bottoms, but instead relies on identifying a series of smaller range, "bunched" bars. When I can identify a series of bunched bars, as I marked on the chart below with two magenta lines, I add in a new Median Line, using the beginning of the bunched bars as my last pivot, or C pivot.



Now it is time to rely on the statistics of the entry and follow the rules I have laid out for myself, because I have done extensive research that tells me the likely outcome of what I see happening here. Remember though, your eyes may not see what I am seeing in real time, so please don't just assume that what you see and read here will translate into instant profits for you. You should only consider attempting to trade this pattern after doing your own research, to make certain that you can consistently see this pattern, and if you can, that it consistently produces a profitable outcome for you. Always approach other traders' ideas this way, please! Make sure it works for you before placing your money on the line.

Once bond futures have bunched or clumped in this multiple bar pattern (I really like at least four bars in the clump, but I prefer to trade on the fifth, sixth, or seventh bar), I enter my orders, which are very simple:

1. I enter on a re-test of the outer parallel with a limit order.
2. My initial stop loss order is always five ticks above the entry order.
3. When I initially began trading this pattern, I always entered a limit profit order for the entire size of my position at eight ticks past where I had entered. If I got my eight ticks, I exited the position. But after trading this pattern hundreds of time, I began to notice that it was quite easy to catch runners, or trades that went quite a bit further than I was looking for initially, without adding much extra risk to the original trade plan. Now I take off half of my position at eight ticks profit using a limit order and immediately put a profit stop underneath the balance of the position two ticks lower, protecting six ticks if the position backs up. The position does back up a good amount of the time, but I find that I catch more than one point on the remaining half about twice a month and I also make a good amount of extra profits on that second half about a third of the time, so the trade off of two ticks seems well worth it.
4. Doing research on the current bond futures market conditions, I have found this pattern currently works throughout the day and even in the electronic sessions.

Here's a look at my set of orders after the market allows me to enter this particular "corner trade":



I got short using a limit sell order at a re-test of the red, down-sloping outer parallel while price was still bunching. I purposely did not wait until price broke below the bunching pattern, because that would expand the size of my initial stop loss order. One of my students in mentoring calls this “Cutting close to the bone.” Because I have entered while price was still within the bunching phase, I can continue to use a small initial stop, and that means the risk/reward doesn't deteriorate too much, even if I only get a half of my position off at eight ticks. Note that the initial part of this trade does give me a risk/reward of less than 2:1, and that is unusual in my trading. In almost all of the repeatable patterns I trade, I require a minimum risk/reward ratio of 2:1, but the high probability associated with this trade dictates that I accept a slightly lower risk/reward ratio to trade it successfully.

The profit order on my first half of the position is eight ticks past my entry, and if that limit buy order at 118 25/32 is filled, I will immediately enter a stop profit order (or profit floor) at 118 27/32. If price backs up, I will be stopped out for an average profit of seven ticks on the entire position for a profit of \$218.75 per contract, before commissions. If price continues to head lower without hitting my profit floor, I will gain additional profits.

I've marked what I consider to be the logical profit target for the second half of this position if price hits my first profit order and then simply continues lower, a test of prior major lows, and of course, if price does head lower through my initial profit target at 118 25/32, I will hide new profit stop orders above any new swing highs that develop as price moves lower (generally three to five ticks above any new swing high).



Price nearly filled my first limit buy order at 118 25/32 and then pulled all the way back to re-test down-sloping outer parallel. For those of you using Median Lines to trade the bond futures, this pullback in price may be an interesting place to attempt a short entry if you didn't know or didn't like the “comer trade” entry technique.

Or, I may be about to be stopped out of this trade for a five-tick loss!

The down-sloping outer parallel marks where price should run out of upside directional energy, and as you can see, it did exactly that. Price plunged after testing the outer parallel and quickly filled my first limit buy order at 118 25/32. Once I was certain I was filled, I entered a stop profit order, or a profit floor, on the remaining portion of the position at 118 27/32.



I was hoping this trade would turn into a “runner” and give me profits above and beyond what the original pattern was designed for, but if price backed up and hit my stop profit, I would still be putting an average of seven ticks of profit in my account on the entire position, which would be worth \$218.75 per contract, before commissions.

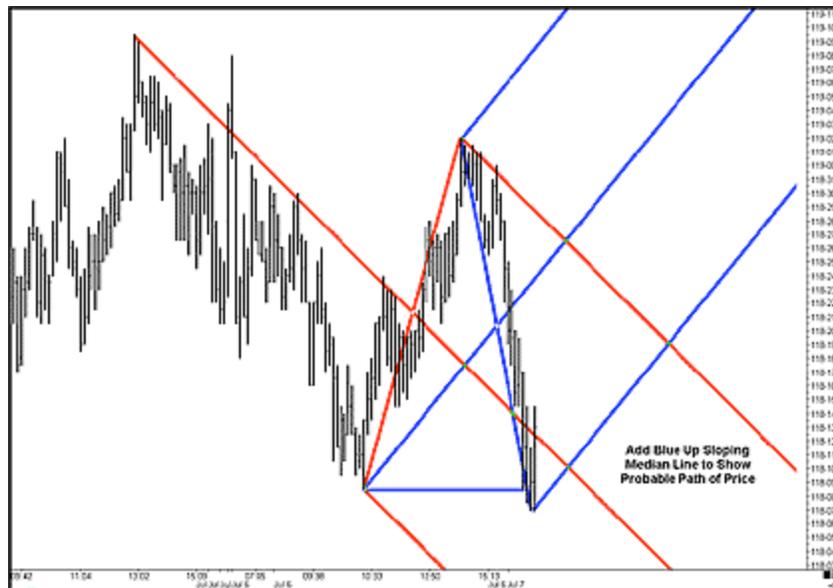


Price literally went vertical and quickly filled my limit buy order at 118 9/32 on the remaining portion of the trade. I initially risked five ticks on this simple, repeatable pattern and netted eight ticks on the first half and 24 ticks on the remaining portion of the position. The first portion netted me \$250 per contract (8 X \$31.25) and the remaining portion netted me \$750 per contract (24 X \$31.25). Both portions are nice profits that unfolded in a fairly short period of time.

Let's see how the market progressed:



Once price tested the major prior lows, it began to bunch, or clump, again. Even though I pointed out that they need not be present, you can see price again left double tops and double bottoms at the extremes of this clump or range. And though the size of the bars are a bit larger than I normally like when looking at corner trades, because price is in the process of testing what was a major prior low and could be an area that acts as support, my eyes are drawn to the clump of bars I outlined with the two magenta lines.

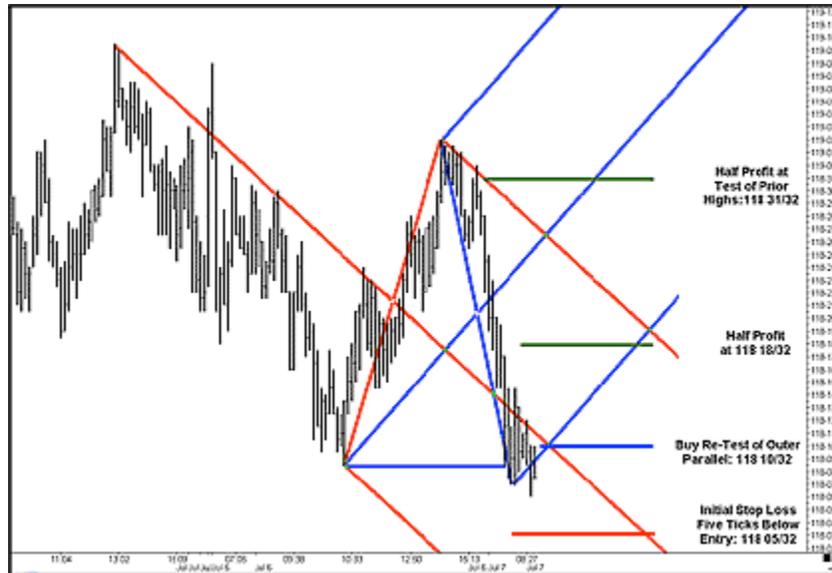


To get a feel for the probable path of price if this clump or corner holds at the prior lows, I add in a blue, up-sloping Median Line and its parallels.

Two things immediately catch my attention: First, price tested the prior low but made little downside progress and quickly popped back above it; and secondly, price traded below the red, down-sloping Median Line, then made some nice progress down toward the lower Median Line parallel, and is now closing back above the red, down-sloping Median Line. This action was described and researched by Dr. Hagopian, a student of Dr. Andrews.

When price breaks through a Median Line or one of its parallels, it should make it to its next most likely line 80% of the time. If price fails to make it to that next most likely line, it is likely headed in the opposite direction and headed there with a great deal of energy.

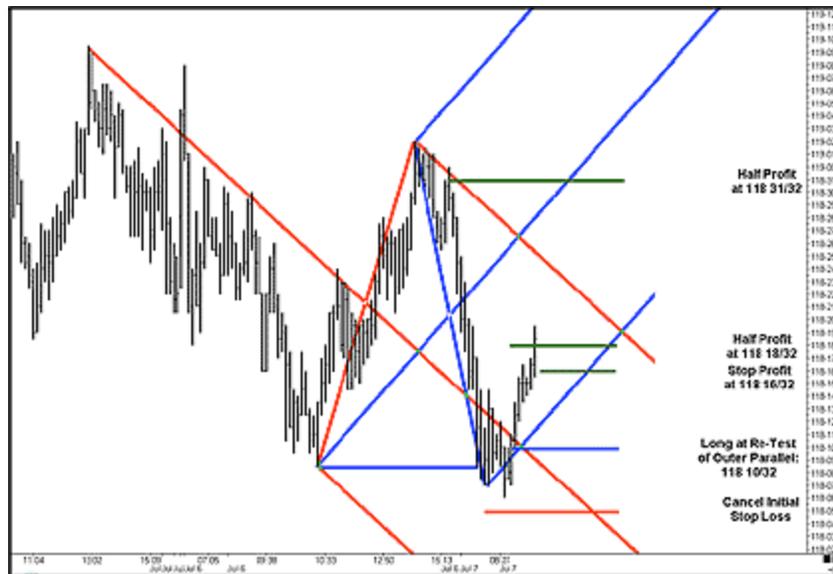
These two together make me like the look and feel of this bunching formation. Let me see what I can do with it:



Now, I am going to be completely honest with all of you: While pondering this formation, I got a phone call from an associate at the CME Group and spent a few minutes away from my trading screen. And when I came back, price hadn't drifted out of the potential corner formation, but several more bars had formed. Because time or space had passed, the formation of these bars has moved my potential entry up by several ticks. I should have been getting long bond futures at 118 8/32, and now, I will have to enter a limit order two ticks higher because price has drifted to the right. Still, however, price is within the corner formation, so I am willing to take the order as outlined above:

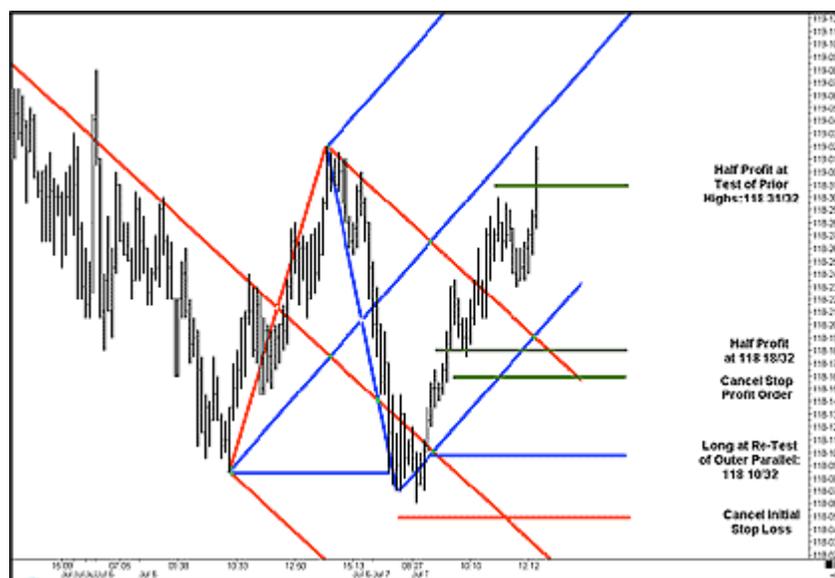
1. I want to buy a re-test of the up-sloping outer parallel at 118 10/32
2. My initial stop loss order is five ticks below my limit buy entry order, at 118 5/32
3. My first profit order will be eight ticks higher, at 118 18/32. If price gets there, I will take off half my position and put a profit floor under the balance of the position.
4. If price continues higher, my second profit target comes in just below the test of the clump of prior highs, at 118 31/32. Price may head higher, but this area may act as significant overhead resistance to further price rises. If I manage to get the remaining portion of the trade off at this level, it will have met all my expectations given the basic structure in front of me as I map this market.

Let's see how price plays out:



Even though I entered my orders late, I still managed to get long this market, so never give up on a trade unless the market conditions change! Sometimes, price gives you a second chance if it is still in the same basic area. Once my limit buy order was filled, price climbed higher in an orderly fashion, and after five or six bars, my limit sell order at 118 18/32 was filled on the first half of my position. I quickly entered a stop profit order at 118 16/32 as a profit floor. If price backs up now, I want to take the remaining profit and walk away. The trade has met my minimum expectations, and sometimes I get more out of a corner trade, sometimes I don't. The key to this trade is to get the eight ticks on a regular basis and then immediately begin working a profit floor two ticks lower. Believe me, if only I always got the eight ticks on these trades that worked, it would still be a trade I would take every time I saw it set up!

Price shot a bit higher and then traded sideways for some time before finally heading higher, hitting the profit target on the balance of my position at 118 31/32. I took 8 ticks out of the first half of this position and 21 ticks out of the second half of this position for an average profit of \$435.12 1/2 per contract, before commissions.



For those of you who are familiar with this particular day in bonds, they actually traded quite a bit higher after my second profit target was hit, but I planned this trade exactly as I presented it here and traded according to my plan. I planned and played the market for what I thought were realistic expectations, and the market allowed me to realize both of my profit targets. The fact that the market traded higher after I took my profits doesn't bother me at all.

I hope you find these examples of "corner trades" interesting and informative. I am currently doing extensive research on a similar type of entry for the currencies, as well as other commodities and futures. Keep your eyes here for an article on that entry technique if it proves to be successful!

I wish you all good trading.

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