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The “Three Up, Three Down” Trading Strategy

Every Monday morning, an hour before the US futures markets officially open, the Chicago Mercantile Exchange sponsors a free, live pre-market session that features me charting various markets while other traders watch via the Internet. We call it the “Market Maps” pre-market session, and the goal is to allow traders and those learning to trade the opportunity to watch a professional trader and money manager prepare for his trading day. I generally cover charts of three or four currency pairs, gold, oil, and a grain market, as well as charts from the US stock market index futures and the US 30-year bond futures.

The original goal of this Monday morning pre-market session was to simply point out what market had been hot the week before, and then, while those attending watched me prepare, point out what markets I felt would likely give the best trading opportunities in the days to come. But two things have changed this general outline: 1) I began offering the same service Tuesday through Friday mornings when it was clear there was a demand for this service; and 2) As I did this day after day for six or seven weeks, it slowly began to evolve into a daily pre-market session filled with market analysis, but with an emphasis on teaching the people who were regularly attending some trading tips and techniques. In many ways, it has become a daily mentoring session for most of the people who attend, and of course, the sessions that were originally designed to average from 15 to 30 minutes now typically run well over an hour—but that's because I am having fun and teaching what I love!

I am a professional trader and money manager and that is my day-to-day focus—it's how I make my living. Most of what I use in my trading is “old school.” You won't find any squiggly computer-generated lines on the bottom of my charts. Instead, I base my trading on time-tested methods that depend on the actual structure of the market, the building blocks that make up the trends and ranges within any given market. My methods focus on identifying those building blocks and taking advantage of their repetitive nature.

I am fortunate to be in what one dear friend at the CME called the “giving back period” of my life. I love to teach, and teaching other traders about the markets—the way others taught me when I was starting out—let's me complete the circle of life. You learn from others, you master your craft, you prosper, and you give back to the community that allowed you to prosper. The community cannot be sustained unless those who prosper give back to the community. In my family, and in Chicago, where I grew up, I was always taught this was the natural way of life.

Let me share with you just how rewarding this can be. This past week, in the Monday Market Maps session, and then again on Tuesday morning, during the subscription Market Maps session, I spent a great deal of time showing traders how to use a very old technique called “Three Drives to the Top, Three Drives to the Bottom.” This technique originated from farmers keeping hand-drawn grain market charts in the 1800's and early 1900's. They found a few patterns that helped them time the hedging of their crops, allowing them to maximize the profits they made when selling their harvested grain or hedging the value of the grain growing in their field by using futures contracts on the US exchanges. One the easiest to use and most reliable was the “1-2-3 Drive” formation. At some point in the mid-1930's, a few farmers sat around a table in Kansas and put together a few of these easily recognized formations, as well as some very simple instructions about using them, into a loose leaf collection and made them available to other farmers, generally through their local farmers bureau, for a very small fee (I believe one of the copies I had originally sold for $15).

Over the years since this information was published by farmers as a simple guide to help each other hedge the value of their grain crops, several well-known analysts have taken this information and put their own name on it, put a few fancy twists on it, and re-named the basic techniques to include either their own name or something that would eventually be associated with them. Again, I was taught to always give credit where credit is due. One of my early mentors would tell me "A student that honors his teacher honors himself." My father would have told me “Don't steal other people's work! If someone taught you how to do something, make sure you tell other people who taught you!”

But even worse than not attributing the original work to these farmers, the well-known analysts have put rigid rules around this very simple technique, each trying to give it their own twist. And when computers showed up on the scene, people tried to make it computer generated and did curve fitting using computer modeling. In the end, this very simple, yet powerful technique that can be done on the back of an old, brown paper bag with a pencil has been renamed over and over and reworked to the point where it has been out of favor for quite some time. So I stripped away the layers of dirt, dust, and old paint and went back to the original material. Then I started showing traders how to use this simple technique as part of their everyday set of charting tools. Let's take a look at “Three Drives” in all its original glory on a chart:

This is a crude oil chart, using bars that are each $1.90 in range from top to bottom. You can see that I marked three trading ranges on this chart and only one of them is a traditional horizontal trading range. Most traders do not realize that trading ranges often have a positive or negative slope. If these sloped trading ranges are wide enough to be traded, I call them “rolling chops.” They are viable, easily spotted trading ranges and that's what first caught the eyes of the farmers many years ago as they watched daily grain prices unfold on their hand-drawn charts (probably drawn on old brown paper bags!).

The really nice ranges unfold to the point where the top has been tested three times (“Three Drives to the Top”), and the bottom has been tested three times (“Three Drives to the Bottom”). It's easy to connect the tops and connect the bottoms, though if you have an eye for trading ranges, you can connect the tops or bottoms after two of them form and anticipate the third test. I call the line that connects the three tests the “Three Drives Line,” but that's just a fancy name for a line that connects the tops or bottoms. Once you have the range outlined, you have two choices: 1) If the range is wide enough to trade, you can trade it in the direction of the trend (buy against the bottoms in an up-sloping range and take your profit as price approaches the top of the sloped range; do the opposite if it is a down sloping range); or 2) You can wait until price breaks above the third drive to the top or breaks below the third drive to the bottom and then find a way to enter in the direction of the newly emerging trend. If you were a farmer 80 or 100 years ago, you would either hedge your grains at the top of the sloped range formation, or if you hadn't hedged and price broke out to the upside, you'd wait to hedge because grains were likely heading higher. If it broke below the “Three Drives Line,” you'd run to the grain elevator and hedge your crops because grain prices were likely heading lower!

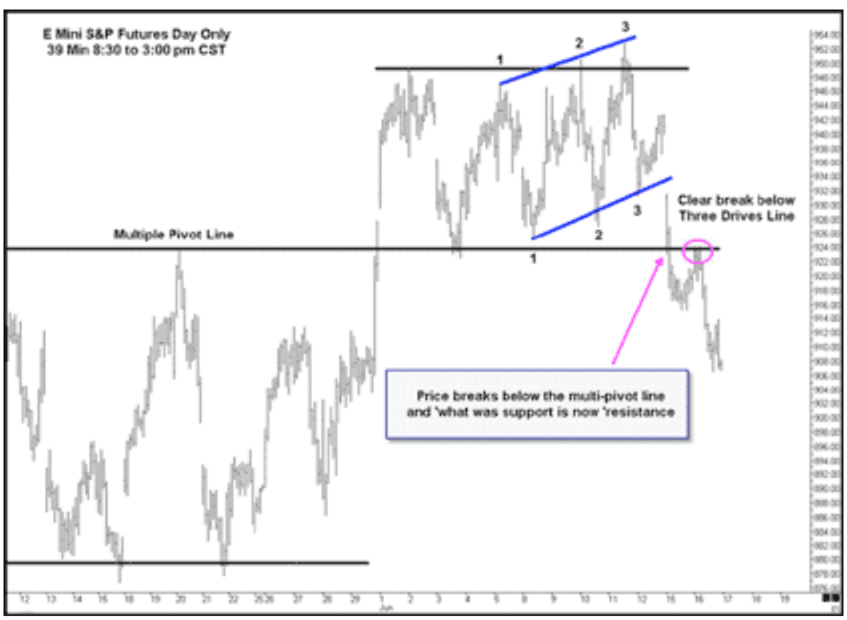
Going back to the crude oil chart, you can see that when price broke above the third drive to the top line in the first down-sloping range, it began a very nice trend higher.

Price did consolidate in a horizontal trading range for a while, but once again, it broke out to the upside and you can see that price ran from about $48 a barrel (where it broke out from the first trading range) all the way to $72.50 before finally breaking below a trading range formed by a three drives to the bottom line around $70 a barrel. That's a very nice run in crude, called by a very simple and easy-to-use trading tool. Is the top now in for crude oil? That's isn't the point, actually. The point is trying to capture the move from $48 a barrel to $72 a barrel.

Let's look at a few other markets to see this simple technique at work. These charts are all from the same day's trading in the stock index futures markets, and I used them to teach the basics of this simple method in the live morning sessions on Monday and Tuesday:

Here's a look at the CBOT mini Dow futures. You can clearly see the three drives to the top marked, as well as the three drives to the bottom. On this chart, I use a Median Line, or pitchfork, to show the probable path of price, but your eyes can easily see the lines that I could have drawn in to connect the three tops and three bottoms. And the break below the three drives to the bottom line is easy to see, and the results quite devastating.

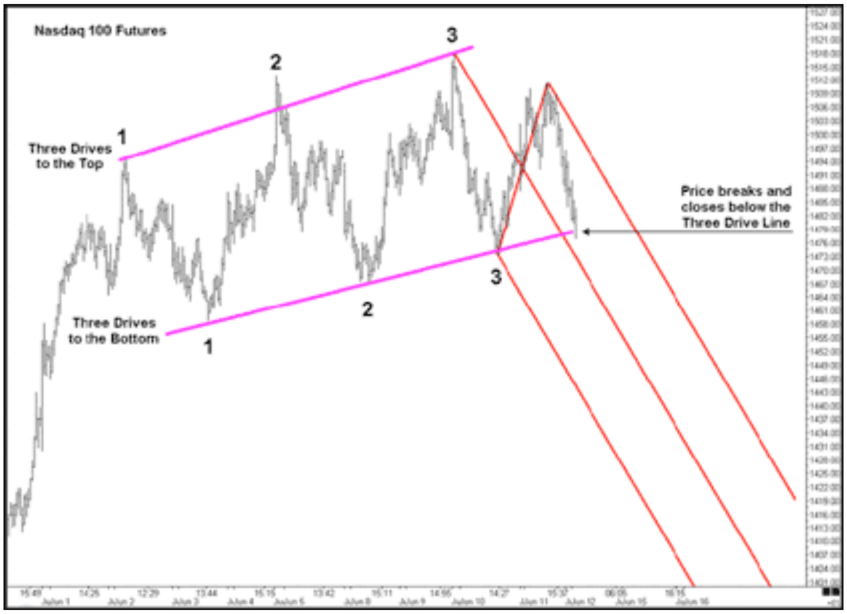
Let's look at another market from that same day:



This is a chart of the e-mini S&P futures. Please note that these bars represent only the “day session” from 8:30 am to 3:00 pm and are 39- minute bars, one of my favorite stock and stock futures time frames because it reflects the cash market open and close.

You can see this range is up-sloping, yet it has three drives to the top and three drives to the bottom and when the three drives to the bottom line is broken, the resulting sell off is a swift one! If you look carefully at this chart and the prior chart, you may find that price did pull back to a logical place for you to enter a short position.

Let's look at another market from that same day:



This is a chart of the Nasdaq 100 Futures from the same day. Note the same three drives to the top and three drives to the bottom that form the sloped trading range. And note that price is just now breaking below the three drives to the bottom line.

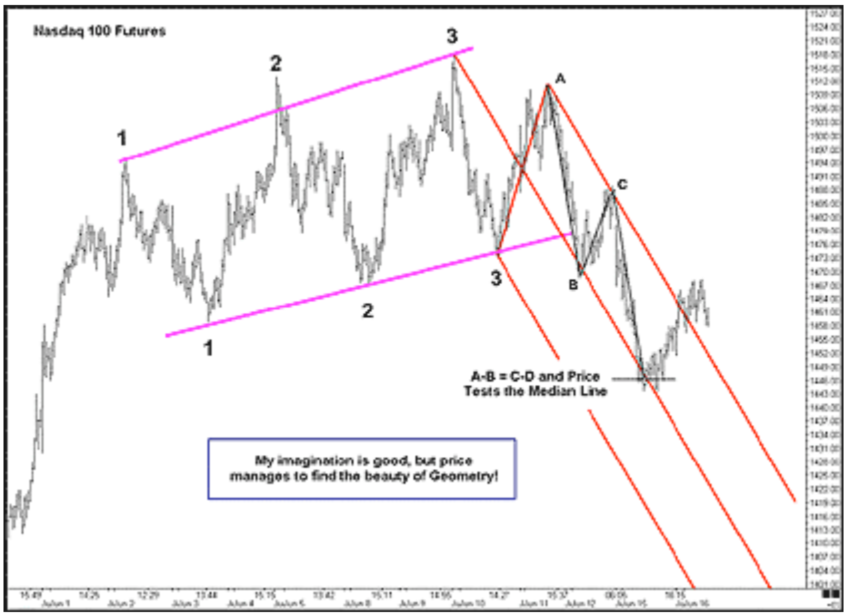
Take a moment to imagine what price might do now that it is breaking this important line.

Did you imagine something like this?

This is what I drew on my chart as a “what if” exercise during the morning session. I thought price might form a trading range, then make its way over to the upper sliding parallel, where I might attempt a short position, and then head lower.

Remember, the Market is always right! We can imagine and think it is going to do something, but in the end, we are left trying to hang on to the tail of the market as it goes where it wants to go!

So, let's now look at what the market did after it broke the three drives to the bottom line. The market's move was more elegant and the geometry was right out of the math textbook Euclid wrote in ancient Greece 2300 years ago! Price retraced to test the upper Median Line parallel, giving traders a high-probability area to enter a short position and then collapsed. And if you simply measure the move, price made a perfect 1:1 movement to the downside, meaning it moved as far down from the retracement as it did in its original fall that broke the three drives to the bottom. And that measured move tested the red, down-sloping Median Line perfectly. Where you would expect price to run out of downside directional energy?



My imagination pales in comparison with the market's natural move, but by playing “what if” before the move unfolds, I am prepared and looking for signs of what the market may give me.

Let's look at another market from that same day:

Here's a non time-based 24-hour chart of the e-mini S&P futures. I have clearly marked the three drives to the top and bottom lines, and you can see price is now breaking below the three drives to the bottom Line.

Let me clean this chart up for you and zoom in a bit:

Now you can see that the second and third drives to the top and bottom, and price, have clearly broken below the three drives to the bottom line. This is how the chart looked as we studied it during the pre-market morning session, between 6:30 am and 7:30 CST.

What will price do now that it has broken below the three drives to the bottom line? Remember, it's more than hour before this market officially opens. I feel the first hour of trading is generally chaotic, because hedge fund managers and stock portfolio managers spend that first hour balancing their positions, not making directional trades.

Let's see what I imagined that morning, well before the market open:

When I looked at this chart during the pre-market session, I imagined that the hedge fund managers and stock portfolio traders would have enough balancing to do to keep prices within a trading range and hopefully give me a chance to enter a short position at a high-probability area. Then I thought prices would eventually begin an accelerated selloff.

My inclinations are interesting and help prepare for what may happen, but what the market actually does is what really counts!

Let's see what the market did on the opening that day. Price sold off immediately, and in a near-vertical fashion. Price came down to test the red, down-sloping Median Line, but I still had not found what I considered a high-probability entry. Then, price slid closer and closer to the upper Median Line parallel, leaving three drives to the top and bottom, if you look closely:

Once price tested the red upper Median Line parallel, I entered a short position with an initial stop loss order above the prior swing high. Note that price is also testing the pink, lower modified Schiff Median Line parallel from below, and this is another reason why price should run out of upside directional energy. This is an area of confluence, where two outer Median Lines cross to form an Energy Point.

Let's see how this trade played out:

Price plunged after testing the red, down-sloping upper Median Line parallel (just above 923.50) and traded down to test the first Warning Line of the pink Median Line set at 909, where I took my profits.

It's often difficult to find a high-quality entry in a market once it has gone vertical, but if you are patient and know your tools, you can usually find an entry when price pauses to catch its breath, right before the ride on the slide resumes.

If you will, please think back to the beginning of this article. I love to teach and I am in the “giving back” period of my career. These moves came mid-day, well after our pre-market sessions ended and too far in advance for me to accurately predict where a probable entry would form. I was able to catch a ride on the slide, but would the traders who attend the pre-market sessions be able to apply these techniques as the day unfolded? Would they find an entry after the break of the three drives to the bottom?

Let's look at two charts I received, unsolicited, after the market closed that day:

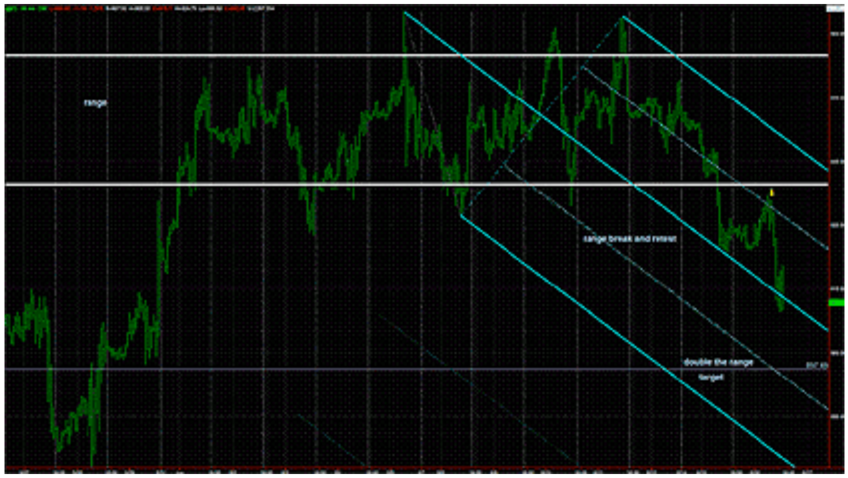
Dave S. sent me this chart after the close, with these comments:

"Hello Tim.

Thanks for spending time reviewing the market structure during your morning sessions. This (chart of the) ES today shows a good example of the 123-hit-the-range-then-break set up the range test 1-2-3 or however it is called. This was another great trade today using the stuff you have taught me in the morning sessions. Again, thanks for your teaching efforts as they have improved my trading."

Dave chose to sell the top of the 1-2-3 range at the test of the down-sloping upper Median Line, anticipating a break of the bottom of the range, and he put his stop above the prior swing highs, much like I did in my own trading.

And here's a second chart, from another trader who attends the morning pre-market sessions:



Wayne T. waited for the three drives to the bottom line to be broken and then sold a re-test of the midpoint line between the upper parallel and the Median Line. He ended up closing his position at 908, earning a nice, 15-point profit.

He said: "I really took advantage of the great trading using this 1-2-3 set up today! My account is growing nicely and I hope everyone is taking advantage of these techniques you are teaching in the morning sessions."

There are traders who can just plain trade, but they don't really have a repeatable trading methodology. I am fortunate to have developed a trading methodology around repeatable patterns and it is clear that this methodology can be taught. There is no better feeling for a teacher than watching their students successfully (and in this case, profitably) apply what they were taught. It is a sign that you were able to teach what you set out to teach, and as a mentor, it is a sign that your own profitability is due to a teachable methodology, not just your own innate trading ability.

I received 15 e-mails that day, all outlining profitable trades in the stock index futures markets. And when I thanked everyone the following morning for sending me their e-mails and charts with the profitable trades, four or five more traders chimed in that they, too, had caught the move and promptly sent me their charts from the prior day! I can't show the 20 or more charts here, but you can bet I felt 100 feet tall that morning! I made a nice profit on the move down the day before, but more important to me, many of the people who attend my morning sessions caught it as well, using a technique I taught them that same morning!

I wish you all good trading.

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