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Tips for Traders | 7/21/2008

How To Avoid Getting “Washed and Rinsed“ in the Markets

I have the honor and pleasure of mentoring a number of very talented traders-some who are full-time professional traders and some that trade part-time. And since I am on my 37th year as a professional trader, I've seen and made most any mistake you can think of or name in my own trading as well.

Taking a loss is a part of trading and no matter how good a trader you become, you will always have losses-and sometimes, you don't see the loss coming, so that's why always having protective stops in the market is so very important. But there are also times when traders get 'turned around' and then the market 'washes and rinses' them, which means the trader gets into a position when price makes a new low or high and then gets stopped out of their position on a pullback and then price returns back to and moves on in the original direction of their position [of course, they are flat now, with less capital].

Taking losses cannot be avoided. Being 'washed and rinsed' can usually be avoided, if a trader knows what to look for, keeps their senses about them and doesn't over trade.

This past week, four of the traders I mentor correctly caught the same Euro USD cash FX trade, avoiding the loss most currency traders took earlier in the day and more important, missing the two 'wash and rinses' that occurred right before the quality trade set up in this currency pair. As I watched each of the traders show me their trade sheets and images and tell me how they stalked the trade and managed to miss the pitfalls, as they told me how they set up their entry and stop loss orders, I had to smile to myself, because one of the joys of teaching and trading is that you sometimes get to enjoy the success of your students and the profits you yourself made on a trade. I also caught this nice Euro USD cash FX trade, so I 'doubled my pleasure' four times as I listened to each of the four students tell me the details of their profitable campaign in their one on one mentoring session the following day. In the next ten parts, we'll take a look at the trade and see what the pitfalls were and how some traders got turned around.and more important, how some traders avoided the pitfalls and found the diamonds in the rough!

You can see in the chart below that as the day started, the Euro was strengthening considerably against the US dollar. These are 240 minute bars so the up trend was strong and had been going on for quite a few days with only shallow pull backs.

Experienced traders should have been hiding their stop profit orders under prior market structures. These areas, prior swing lows for example, are areas where limit buy orders have been left by other traders as entry orders to initiate new positions in the direction of the current up trend. These limit orders tend to act as protection, unless an acute pull back begins-and generally, if a pull back is steep enough to break much below these prior market structures, it's best to have a stop profit order in the market and let it 'take you out of your position' at a nice profit. Once out, you can re-evaluate the market after your head is clear and if a new trade set up develops, you are ready to take a new trade!

I am going to switch to candle stick bar style charts for the next two charts, because it will be easier for everyone to see just how dramatic the first move in this series of moves was:

This is a chart of the same period, using candle stick bars instead of a traditional 'open, high, low, close' style bar chart. I generally chart using traditional bar charts, but there are times when I am presenting material when candle stick charts can really show everyone what **my** eyes see when I look at a movement using traditional bars.

Now let me show you what happens, using candle stick bars, when the majority of the market gets caught with the same directional position and most are not using adequate stop loss or stop profit orders in their trading.

Price made a marginal new high for the move and then simply plummeted. Although some traders were probably working stop profit orders, most traders got caught holding long Euro positions against the US dollar that quickly lost quite a bit of value.

As the second bar closes, the action is still quite hectic and it was clear from talking with many of my contacts within the cash FX community that most traders were long cash Euro FX and got caught because they were using inadequate stops [or weren't using stops at all!]. This may have exaggerated the move—but in any case, all traders should have been working either stop losses below their long Euro FX positions or stop profits if they had profits in the positions to protect. Those traders that were working either scrambled to get flat or sat, frozen, while their positions went against them and their losses mounted.

Let me repeat my number one rule: ALWAYS trade with stop loss orders or stop profit orders in the market! You must protect your capital at all times!

Now let's switch back to a traditional bar style chart and evaluate where the market is at when this wide range bar lower closes.

A surprising number of traders continue to use lagging indicators like moving averages, MACD, stochastics and simple 'loose fit' trend lines that are off set a small distance from the action. Their thinking is that these indicators keep them in long-term trending markets, thus letting them 'catch the big ones'. You can see from the chart above that the 'loose fit' trend line has not yet been broken, so even though the series of prior lows that formed a shelf of support was broken, many traders still have not exited their positions; in fact, most lagging indicators still had not turned down, because this is only the second bar with a lower close. As hard as it is to believe looking at this chart, a good portion of the market is still long Euro FX against the US dollar as this second bar closes!

I said earlier that losses are a part of trading. In my opinion, the traders with long positions should have been stopped out of their long positions long before the close of this bar, either with a profit because they had entered much earlier in this strong up trend or a loss, because their stop loss order was executed as price turned down hard. Those traders still long at the close of this second bar are afraid to take the loss, frozen by fear and greed.

Even though price continues lower, in the chart below you can see the size of the bars have begun to normalize and price is trading in an energy coil or trading range.

This leads many of those traders that are still long to begin to feel that maybe this down side correction is over—in essence, they are HOPING it is over, and once you begin to rely on hope as a trader, you are in serious trouble. Not only are you likely to take a loss on your current position, you are also likely to continue to trade with false hope. You are lost and alone and fear and greed are eating you alive!

Let’s see what the markets have in store for those folks.

When price breaks out below the energy coil, the lagging indicators are also turning lower. All those traders that were relying on hope now exit their positions. And something worse happens: Because they weren’t using stops, they are turned completely around. When price breaks below the trading range, they stop themselves into a new position. They sell the cash Euro FX against the US dollar, partly because of the new lows and partly because 99 percent of the lagging indicators have now finally turned down hard. Eager to recover the money they just lost, they jump on what they now perceive as the ‘new’ down trend.

What does the market have in store for them now? Redemption or further torture?

When price breaks back up into the trading range, the traders that just went short at new lows begin to have a sickening feeling in their stomachs: Did they just exit and get short at the low for the pull back?

And when price breaks above the trading range, the torment intensifies. Most traders that got short at new lows now stop themselves out of their poorly conceived short euro FX positions. And unfortunately, a good many of these same traders now get long cash euro FX against the US dollar, reversing their positions yet a third time!

This move is known as a ‘wash and rinse’ and it frequently catches traders that have just taken a poorly planned loss in the market. Some people may argue that no loss is well planned, but as I stated earlier, losses are a part of trading, so if you were working a stop loss order or a stop profit order, the execution of either of those orders should not have bothered you: When these orders were filled, it was a part of your original plan. Traders that had no plan were left wondering when to get out, how to get out and once out, what to do next. And many of those traders stopped themselves out of their long positions and then stopped themselves into new short positions when price broke below the narrow trading range—right before price rallied out of the hole.

For most of these traders, there is no planning and analyzing going on here—there are only reactions to market moves that stay one step ahead of them. The more these traders trade without plans, the more turned around they become. They are literally setting their capital on fire and their trading accounts are going up in smoke!

Is the torture over? This was a clear ‘wash and rinse’. Has the market now returned to a more normal state and have the majority of traders now found their way back to the ‘trend’?

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Median Lines are one of the few indicators I can name that do not lag the market. They are predictive in nature and have a mathematical set of statistical probabilities associated with them when they are first drawn. When price finally shows a sign of strength by breaking above the top of the narrow trading range, I draw in a new blue up sloping Median Line and its Parallel Lines.

I'm not ready to trade yet, I don't have an opinion yet, but this sign of strength has me interested, because many of the long positions in the market were 'washed out' by that steep down move. I'll watch a bit and see if this Median Line and its Parallels helps me spot an entry I recognize as a high probability trade entry set up that I trade on a regular basis.

Price pulls back again, below the low of the narrow Energy Coil or trading range. You can imagine that the traders that went long again on the break above this same narrow range are pulling their hair out in frustration as they chase price up, down and sideways. Many of them exit their new long positions at a loss when price closes below the trading range; some hold their position, but few of them have a plan or can stomach much more of this type of torture.

If you look closely at the Lower Median Line Parallel I added to this chart, price has now come down to test it. This is the first 'test' of the Median Line and its Parallels and price closes on the Lower Median Line Parallel with no separation—that means it literally closes on the line. This gives me no clue whether buyers or sellers are currently in control of the market, so my decision is simple: I'll wait and watch another bar form. Price will tell me when the buyers or sellers are in control—and until then, I will simply wait patiently. I never chase the market. I wait for trade entry set ups I recognize and they all begin with a sign from the market that either the buyers or sellers are in control.

Rather than buying or selling a break out, I look for high probability trade entry set ups, ones that repeat over and over and that have an associated statistical probability of success of well over 65 percent. I wait until I see these set ups form and if none form, I continue to wait. I always trade with a plan and use surgeon-like money management, using stop loss orders, stop profit orders, and limit buy or sell orders to conserve capital while a plan matures. I never chase price. If a set up doesn't appear, I wait patiently, because eventually, one WILL appear. Then I plan my trade and execute my plan.

In the chart above, you can see that after many traders got stopped out of their original long euro FX position and then got short and then long and then short again as price traded below, then back above, then back below the trading range, I am just now starting to see signs that a high probability trade is setting up. I've spent none of my capital and none of my emotions in this hectic directionless trading. I am calmly waiting for a trade set up that I recognize.

After the first bar tested the Lower Median Line Parallel and closed on it—leaving me no clue whether the sellers or buyers were in control—the second bar also tested the Lower Median Line Parallel. Note that it broke below the line by about the same distance and then closed above the line with good separation—a sign of strength, and one that tells me there are now buyers in the market.

Now, I draw in a new line, a line with the same slope as the Lower Median Line Parallel that connects the lows of the last two bars. This is a Sliding Parallel and it shows me where price has support [in effect, where other traders have put limit buy orders to enter fresh long positions].

I now have an indication that buyers are in control of this market and I have the beginnings of a high probability trade entry pattern. Let me draw it out for you:

If price pulls back to the sliding parallel, I will buy the re-test of the Sliding Parallel at 1.5642

My initial stop loss order will be five ticks below the low of the bar that first tested and peeked below the Lower Median Line Parallel, at 1.5629

If I am filled on my limit buy order at 1.5642, my profit target will be where price intersects with the Median Line, at 1.5849

I am risking 13 pips on this trade to make a potential 207 pips. That gives me a risk reward ratio on this trade of 207/13 = 15.9 to 1

Because I am using 240 minute bars, I expect I will have to hold this position overnight, so I am looking for high risk reward trades. This is a very nice risk reward ratio with a very small stop. I will certainly try to enter this trade.

Price came down and tested the Sliding Parallel again two bars later. Note that I had to move my limit buy order from 1.5642 to 1.5649 because the Sliding Parallel has an upward slope. I was able to get long at 1.5649 near the low of the second bar. Then price climbed quickly out of the hole and the same bar closed near its highs, with great separation above both the Sliding Parallel and the Lower Median Line Parallel. This is a great sign of strength and it reconfirms that there are buyers below this market now and they are currently in control of the price action.

Once I see my price print, I check that my order is filled. Then I double-check that my initial stop loss order is still working in the market. Now I place my profit order, a limit sell order at 1.5849 in the market.

Price moves higher in an orderly fashion. After leaving triple tops and a spike slightly higher, it dips to re-test the Sliding Parallel. When it quickly climbs back higher and makes a new high for the move, I cancel my initial stop loss order at 1.5629 and replace it with a new stop profit order ten ticks below the spike low that just re-tested the Sliding Parallel, at 1.5678.

I am now playing with the market's money, so it is now a matter of managing the trade, looking for ways to minimize my risk while trying to allow the trade to mature. This is the part of trading that many traders find tedious and tend to neglect, but it is this part of trading that can really maximize your profits once you master money management.

Note that I also cancelled my original profit target at 1.5849 and placed a new limit sell order at 1.5900, because the Median Line is an up sloping line and as price moves to the right on my chart, I need to get paid more for taking the risk of holding my position longer.

After I cancel and replace both my stop profit order and my profit order, price consolidates in a narrow range. After four relatively narrow range bars, it spikes higher again, making another new high for this move.

I cancel my stop profit order at 1.5678 and replace it with a new stop profit order ten ticks below the low of the narrow range, at 1.5751. Then I cancel and replace my profit order, moving it from 1.5900 to 1.5927 because the Median Line is an up sloping line. The longer I am in this trade, the longer the time my capital is at risk, so I need to get paid more if I am going to stay in the trade longer. I keep moving my profit target higher by measuring where price will intersect with the Median Line after each bar closes and adjusting the limit sell order to that level to try to capture the maximum profit.

I am able to move my profit order higher one more time, by eight pips, and then price hits my limit sell order, taking me out of my long euro FX position at 1.5935 for a profit of 286 pips. My initial risk on the trade was 20 pips, so this trade had a tremendous risk reward ratio.

For me, the good feelings came not only from taking a nice profit out of a hectic market: Four of my students also missed stepping on the land mines and caught at least a good portion of this same trade to the upside. Watching traders that I mentor one on one, catch trades like this brings me great joy and satisfaction. They didn't chase price, they didn't get turned around while price broke below and above and below the Energy Coil—instead, they waited for a high probability trade entry set up that they knew how to trade. When it began to form, they planned their trade and then traded their plan. This is the key to consistent profits in any market.

Let's see how the day ended:

You can see that I might have squeezed out a bit more profit, but by using the Median Line as my target, I got out cleanly and then when price pulled back, instead of having my profit stop hit at a lower level than where I took my profits, I was out and looking at other opportunities. There would have been nothing wrong if I had exited when a profit stop was hit, but I particularly like getting out of my positions as cleanly and as quickly as possible once a trade has reached a logical profit area.

There are very important lessons embedded in this set of images and the dialogue attached:

1. Always use stop loss orders and stop profit orders.

2. Always plan your trades in advance and always trade your plan. Freelancing or chasing price as it makes new highs or lows can devastate an account.

3. Trade using high probability trade entry set ups that you have seen repeat over and over and know the success rate of the trade entries you are using. Do your own research—don't take anyone else's word about the success of ANY technique. It is your capital on the line, so you must be responsible for it.

4. The longer you are in a trade, the longer your capital is exposed to an unexpected market shock, so you need to get paid more as time goes on.

5. Always have a realistic profit target and exit cleanly if possible. If your profit stop is hit instead, that's part of the plan—it preserved your profits and may have saved you from turning a profitable trade into a losing trade!

I wish you all good trading!

Timothy Morge
tmorge@sbcglobal.net
www.medianline.com
www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
1870 Diamond Creek Lane
Aurora, IL 60504-3441
630/236-3441
Fax: 630/236-3448
Web sites: www.marketgeometry.com or www.medianline.com