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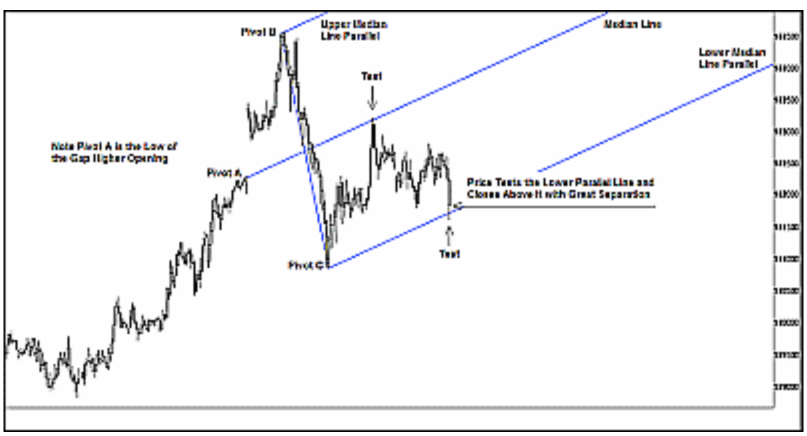
Tips for Traders | 9/29/2008

Getting Paid to Trade by the Market

Most retail traders think the hardest part of trading is recognizing whether the market they are trading is about to go up or down. Don't get me wrong: Getting the market's direction is of key importance! But the real test of whether you will make it as a trader year after year is if you can find a way to take profits out of the markets you choose to trade on a consistent basis. To do this, you have to be able to read the markets; you have to have found a style of trading that fits your own personality; and you have to have refined and mastered this style-finally, you have to embrace money management and use stop, profit, and entry orders effectively in your trading.

I want to show you a method that some of the students I mentor have embraced. There are a few variations of this same idea being used by different students, but it all comes down to this: There's a time when you have a certain amount of potential profit in a trade where you know you not only can no longer take a loss on the trade, but because your capital has been at risk and this has become your daily job, you need to capture some of that potential profit sitting on the table in case the market backs off and yet you still need to participate if the market really takes off in your favor. It is a difficult balancing act, especially since you have to maintain a meaningful risk reward ratio while doing it, but several of my students have adopted this method, and it works very well for them.

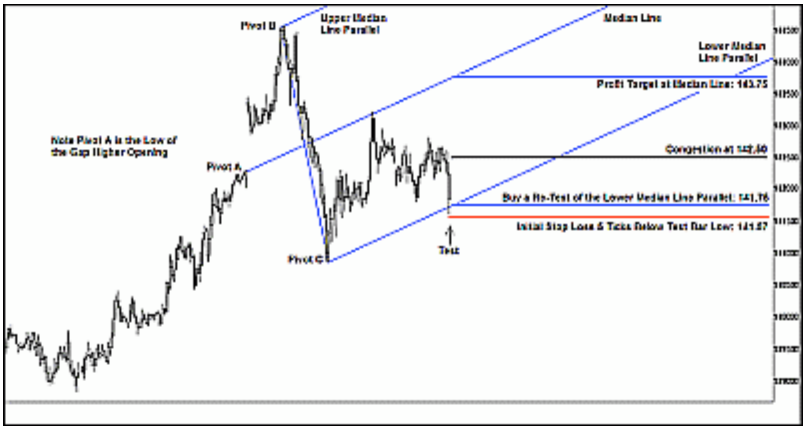
Let's take a look at a set of charts and see how they are doing it:



The Euro FX is strengthening nicely against the US Dollar-you can see it gapped higher on Sunday. Price continues to rally for some time and then sells off nicely. Note that the blue up sloping Median Line set drawn here used the low of the weekend gap as Pivot A [this is called a Gap Median Line].

Price has already tested the Median Line from below and the Median Line did a great job showing where price would run out of directional energy-this gives us confidence that this line is vibrating at the same frequency as price and will likely continue to predict the probable path of price in the future.

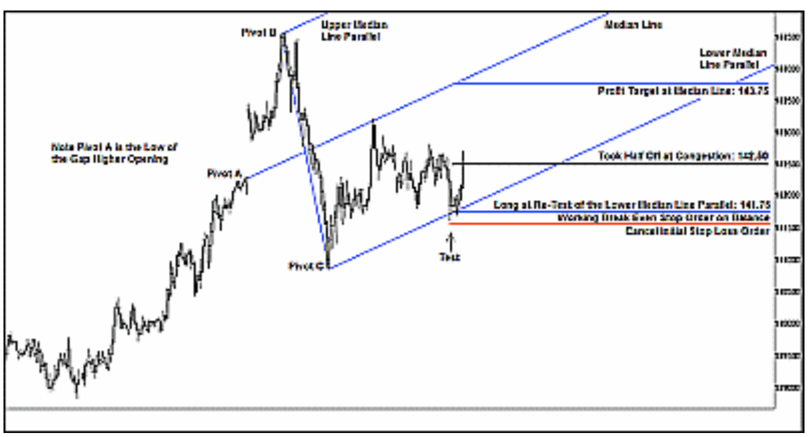
Now look at the last bar on this first chart: Price comes down to test the blue up sloping Median Line Parallel. It briefly peeks below the line but closes well back above it, with great separation, which is a great sign of strength. This is the second successful test of this Median Line set and once again, the Median Line set showed us right where price should run out of directional energy. Once this second test happens and price closes well above the Lower Median Line Parallel, it's easy to diagram a high probability trade entry set up:



Because price tested the Lower Median Line Parallel and even peeked below it, running any stop loss orders if they were there, and then closed well above the line—a great sign of strength—we're looking to get long the Euro FX against the US Dollar if price comes back and re-tests this Lower Line. The initial stop loss will be five ticks below the peek below this Lower Line and the profit target will simply be the Median Line, at 143.75.

This is a classic 'test and re-test' trade set up that is my number one high probability trade entry in my own trading. I go over this set up and my other four favorite high probability trade set ups in one-on-one mentoring time and time again, so my students know these trade set ups in their sleep!

A few of my students have put in a twist of their own on these same high probability entries, and although it's all about 'getting paid', we've begun to call it the 'Bread and Butter' method of managing these trades once you get them on. Let's see what it looks like:



Price came down, getting everyone long at the re-test of the Lower Median Line Parallel. After a few bars of congestion, price finally started to trade higher. As price moved higher, the prior Swing High and area of congestion was staring everyone in the face. IF this trade was going to fail, it would fail at a test of this prior Swing High and area of congestion—a prior regional top in the market. There is no sign that this trade is not going to continue higher to the Median Line at 143.75 [and perhaps move even higher!].

But the trade has been open for some time now and as it approaches the area of congestion, the trade has a potential 75 ticks of profit in it. We can't let it turn into a losing trade now. One choice would be to move the initial stop to a break even stop. There is no market structure to hide any stop profit orders under [areas where other traders have left limit buy orders that will act as buffers to protect our stop profit orders]. Price has moved higher in a straight line, so the best we can do is move our initial stop loss order up to a break even stop order.

But if price trades back to break even now, we'll have left 75 ticks of potential profit on the table, had our capital at risk for all this time, and gotten nothing out of this trade [in fact, we'll still be paying brokerage on it!].

What else can we do?

Instead of moving our initial stop loss order up to a break even stop order, we now take half the position off at the congest area, locking in 75 ticks on half the position. Now if price backs off, and we stopped out of the second half of the position, we'll still have been paid for having our capital at risk. And if the market continues to move in our favor, we will still participate in the move with half our original position.

As long as we understand how this affects our risk reward ratio and are willing to accept the risk reward ratio of the entire position, win or lose on the second half of the position, this can be a very powerful money management tool! Let's see what the market gave us on the second half of this position:

You can see that after we took profits on half our position at the congestion area, price stalled and turned back lower. When we took profits on the first half of our position, we moved our initial stop loss order to break even and price did come back lower to stop us out at break even on the second half of this position.

Because we locked in 75 ticks on half the position, we got paid for having our capital at risk and lost nothing [except for the cost of brokerage] on the second half when price retraced all the way back to our original entry area.

As I said at the beginning of this piece, I have a handful of students in one-on-one mentoring using different variations of this same technique. Some cut their positions into thirds, some always take a portion of their position off at a set number of ticks, and others always run trailing stops under a portion of their original position—all of them work to get to break even stops on their positions as quickly as possible while maintaining a solid risk reward ratio.

I've showed you how these traders I mentor make 'Bread and Butter' trades to keep putting money in their pockets. I call it 'making donuts' and another long-time professional trader friend of mine calls it 'slicing sausage'. The key is the same: find a way to consistently put money in your pocket and over time, if you are using good risk reward ratios and solid money management, your pockets will fill up!

I wish you good trading.

Best,

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