MONEYSHOW.COM
INVEST SMARTER, TRADE WISER

Tips for Traders | 12/8/2008 11:07:00 AM

Seeing Through the Eyes of a Professional Trader

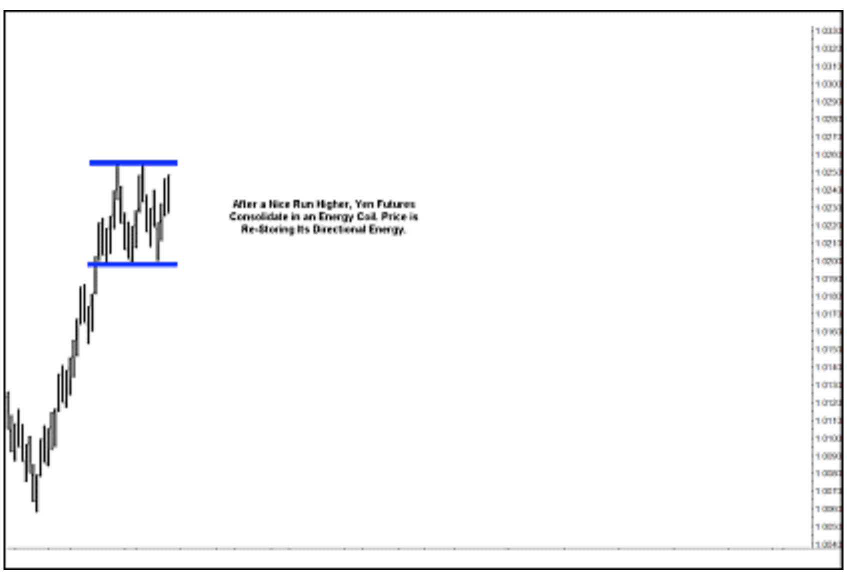
I have been a professional trader now for more than 37 years. I think I have seen just about everything there is to see in the trading world. Sometimes, I watch the market and I literally ask myself, “Why are these people torturing themselves?” You would have to be able to see through my eyes to understand what I mean.

Maybe you *can* see through my eyes—well, maybe I can *try* to show you what I see through my eyes.

I learned about trading in my early teens by updating a scrap yard owner’s hand drawn commodity charts. He was a friend of the family and he hedged the large piles of metals, like copper, in his scrap yard on a regular basis—and he also liked to trade metals, especially copper futures.

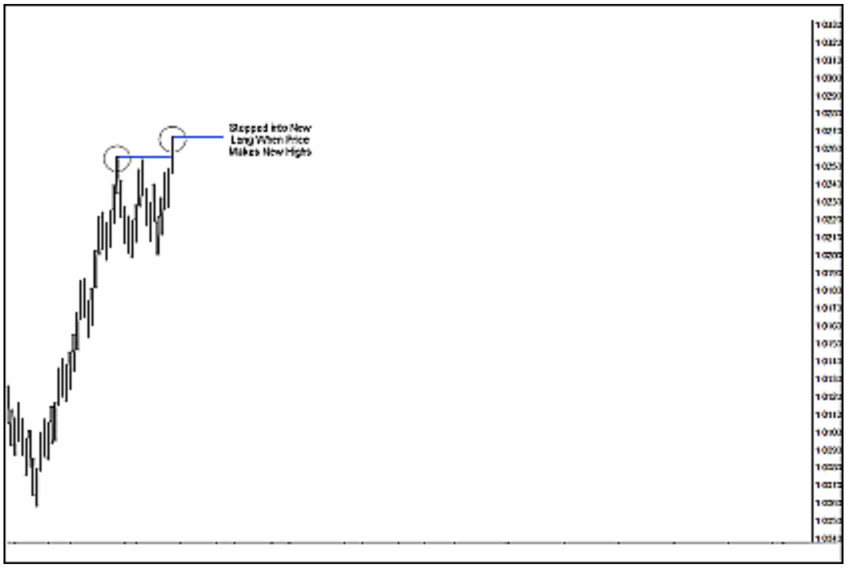
One of the first chart formations I watched him trade successfully was something he called a “rolling chop.” It wasn’t a trading range and it wasn’t a trend—it was something in between. This formation has just enough down side or up side bias to it to get speculators interested in establishing new positions because they *think* a new trend is starting—but there isn’t enough follow through to keep them in their positions. I like to think of it as a trading range that has a slope to it. He named it “rolling chop” because these formations tend to roll on and on, chopping up more and more participants.

So let’s take a look at one of my favorite formations, the rolling chop. But we’re going to look at the market two ways. First, I’ll try to let you look through my eyes as I watch a group of typical breakout or momentum traders trying to trade their way through a rolling chop. Then, I’ll try to let you look at the same market using the market tools I use to frame the market (or give the market context some perspective). I hope you’ll be able to see what it’s like looking through my eyes—first watching other traders trade a market using their tools, and then watching through my eyes as I trade the same market. Let’s give it a try!

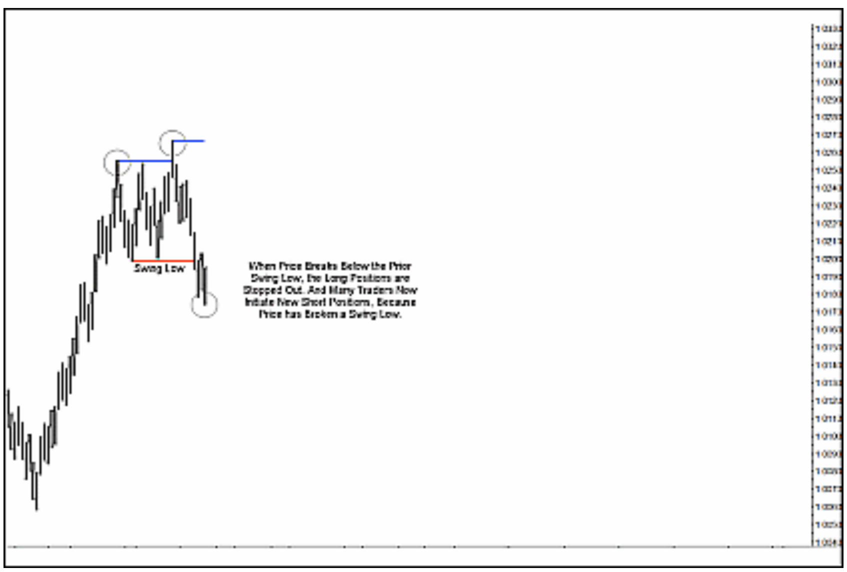


Price has a very nice run higher and then slows down and consolidates in a trading range. The market ran out of upside directional energy and it is restoring that spent energy, or resting. Once it has restored its energy, it will move out of this consolidation area, or Energy Coil.

I don’t yet have a clue which side price will choose to break out of. Do you?



After restoring its energy, price now trades above the prior high for the move. The typical break out trader leaves stop buy entry orders above the prior swing high, hoping to “catch a ride” when price does break out of the trading range. They believe that price will continue in the direction of the breakout because of its momentum. Price closed on its highs and the typical break out trader is now long.

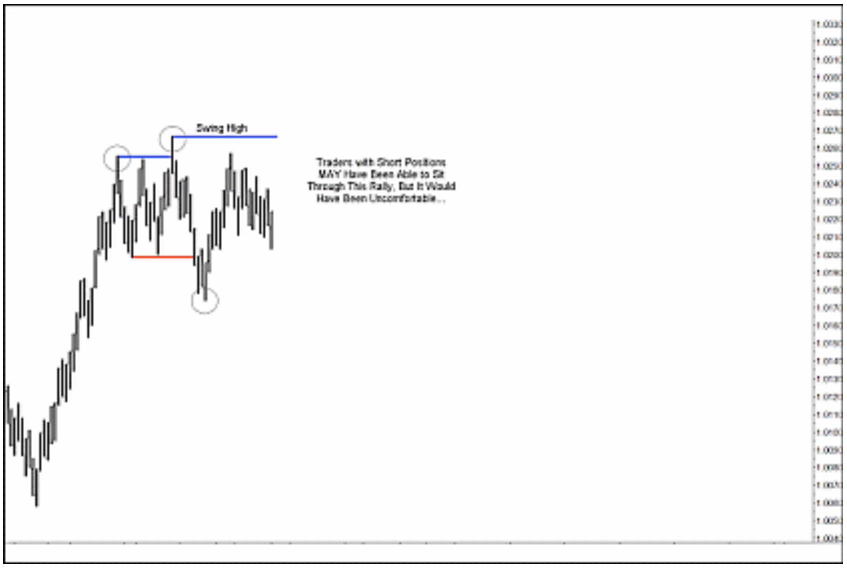


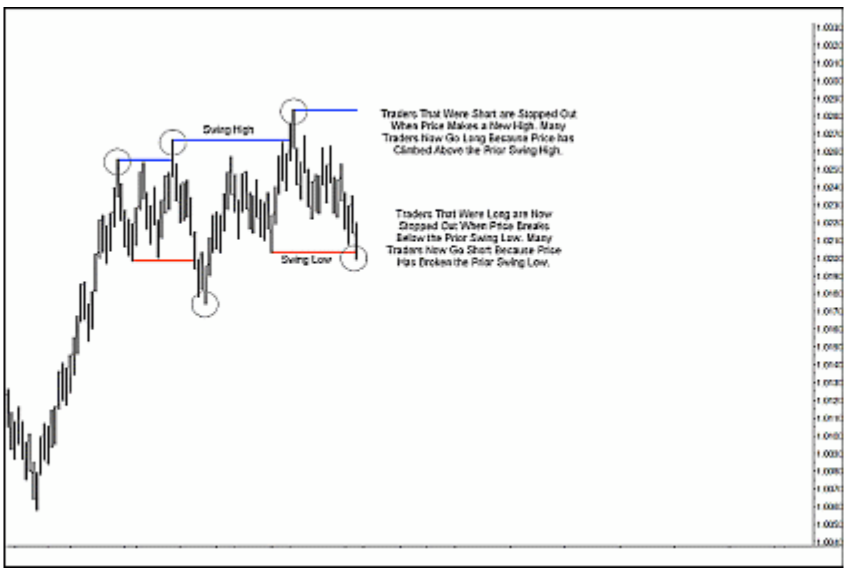
Price didn’t go much higher—in fact, it didn’t go any higher than the high and close of that first bar that broke above the trading range—the bar that stopped break out traders into their long positions.

And then price traded sharply lower. Price ran straight through the trading range and made new lows, trading below the prior swing low. That triggered the break out traders stop loss orders, and they exited their long positions as price broke below the trading range.

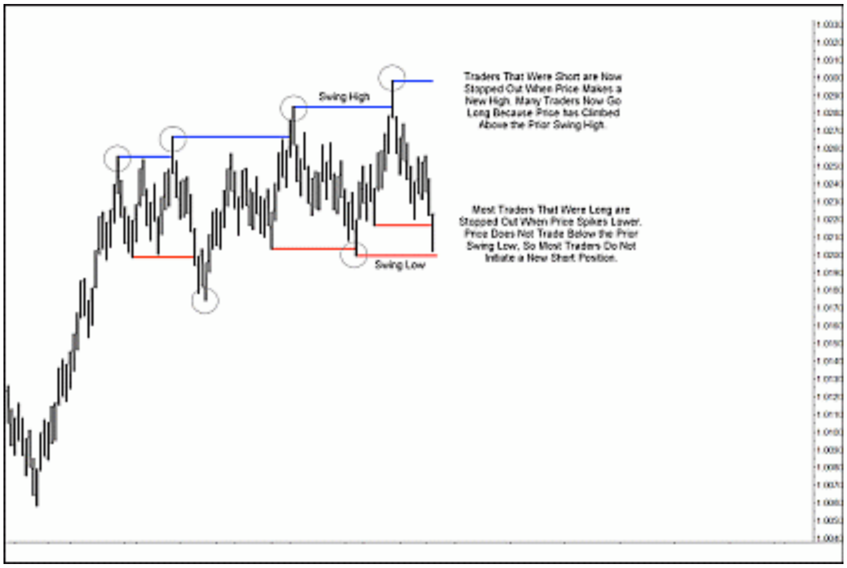
Many break out traders actually exited their long positions and then went short when price made those new lows. They stopped and reversed to short positions because price broke below the prior swing lows. Once again, they were hoping to catch a ride when price breaks through a price extreme.

Price rallies hard but fails to break above the prior swing high. The break out traders *may* have been able to stay with their short positions, but it’s been a rough ride.



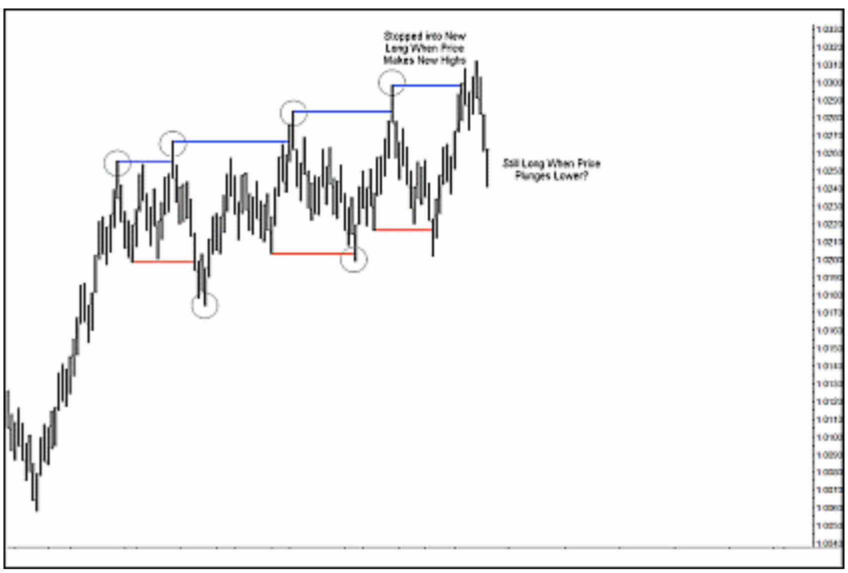


Traders that were short get stopped out for a loss when price makes a new high. And many of these same traders leave stop entry buy orders above the prior swing high, so they stopped themselves out of their short positions and have now stopped themselves into new long positions as price breaks above the prior swing high.

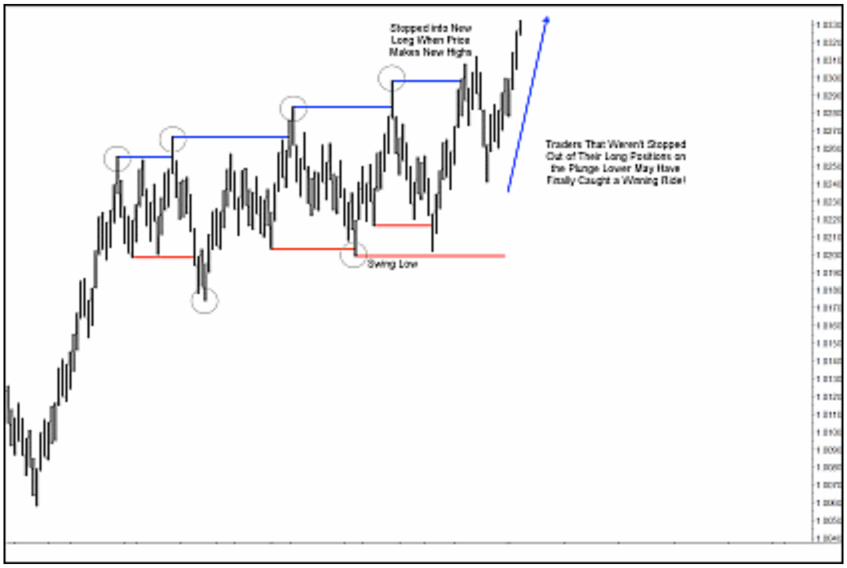


Price rallies hard again, making a new high. The break out traders that were short are now stopped out of their short positions as price makes a new high. And because price broke above the prior swing high, they go long as price makes a new high.

Once the stop loss buying dries up, price spikes lower. Price trades low enough that the majority of the long positions get stopped out for a sizeable loss. But this time, price doesn't trade below the prior swing low, so it never triggers the new stop entry sell orders. Most traders that were long were stopped out of their long positions, but probably didn't go short on this run to the down side. Most traders are now flat.



Once again, price trades higher and makes a new high, triggering a new round of stop entry buying from the break out traders. As soon as all the stop loss buying pressure to the up side stops, price turns lower. It may not yet have traded low enough to trigger stop loss sell orders on the new long positions, but once again, it's been a very difficult ride.

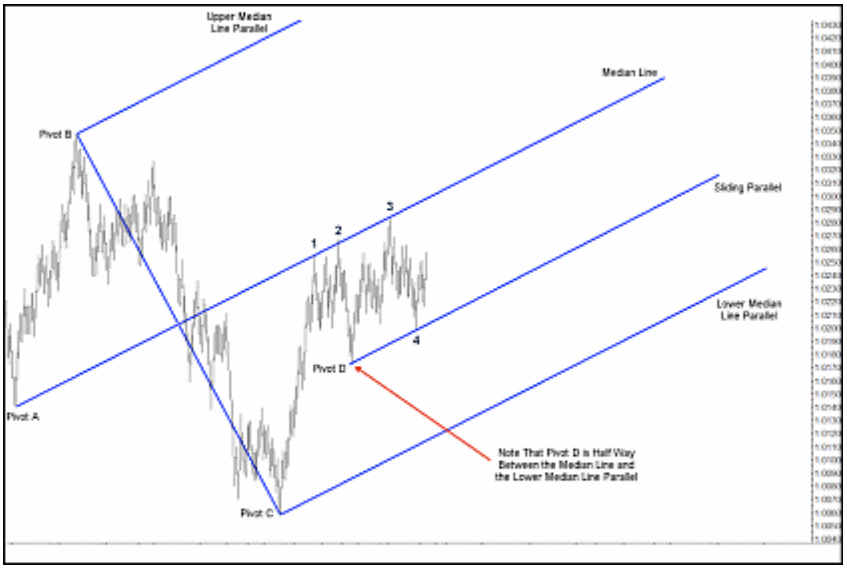


After a bumpy ride, price is finally making new highs and seems to be holding onto its gains. It looks like the break out traders may have finally "caught a ride!"

I can't imagine the emotional strength someone trading that style must possess, not to mention the account size! But I know lots of traders that tout break out trading. And I watch the market make these same formations over and over again. If you've ever seen them yourself and wondered what's making the market behave in this fashion, I hope I just gave you a small insight into a different trading style.

Are there break out traders that make money when you look at their accounts over long periods of time? One of the most famous break out traders is Richard Dennis. You may remember he taught about 15 “turtles” to trade a specific break out methodology in the mid-1980’s. Rich is still trading, and he’s made quite a lot of money in the markets over the years. But if you know anything about him, you also know that his P&L swings are infamously large! This trading style is not for the meek of heart!

Let’s take a look at how I traded this same market, during the same period, using my tools. Come take a look through my eyes at my own trading:



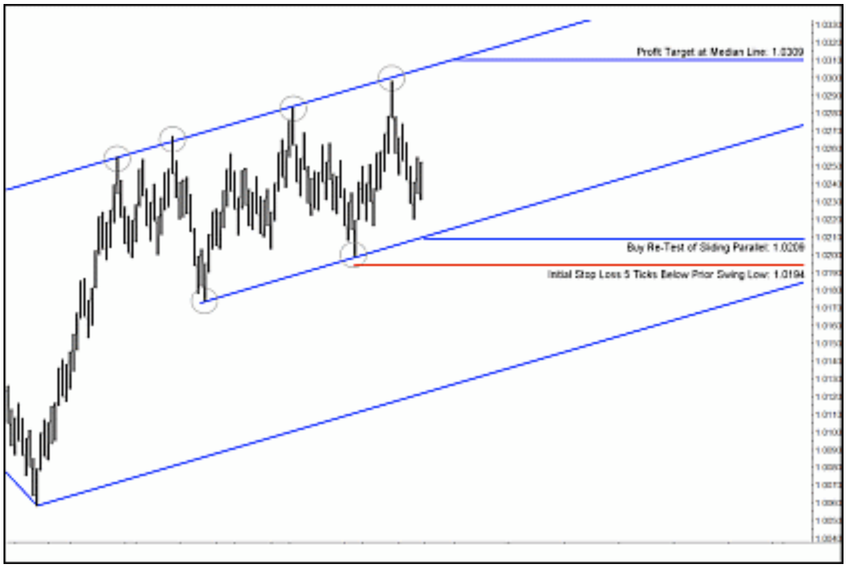
I pull back and take a look at the market context of the current trading range, or “rolling chop.” I add in a blue up sloping Median Line, and when I notice that price has touched the Median Line from down below three times and left two lows that seem to be the same distance from the sloped Median Line, I add in a line with the same slope that connects those lines—a Sliding Parallel.

And once I add the Sliding Parallel, I note with interest that it is about half way between the Median Line and the lower Median Line parallel. In the past, I haven’t paid much attention to the half way point between these lines, but a few of the more accomplished traders in my mentoring program have shown me, with their own charts and hard work, that there are times when this area has real merit.

I think I have marked the area where price should run out of up side directional energy (the Median Line) and where it should run out of down side directional energy (the Sliding Parallel).

Now what am I going to do with all these lines?

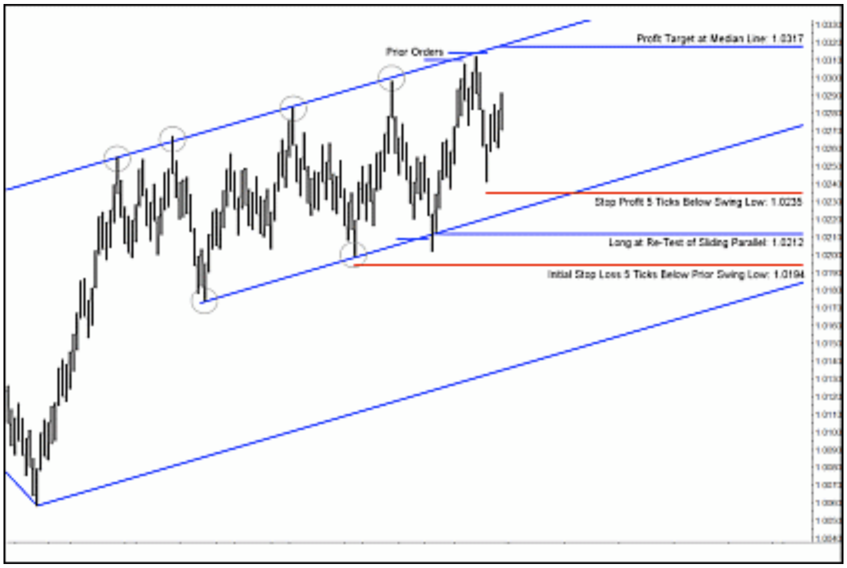
Here's a closer look at this formation. I call it a "rolling chop," but break out traders may call it a "death trap." I don't want to sell at or near the bottom of this formation (and remember to take the slope into account!) because this formation does have a positive slope. I want to buy at or near the bottom of this formation —against the Sliding parallel. But I'll only be willing to do that if I can enter a limit buy order at the Sliding Parallel and then put my initial stop loss order below the prior swing low, where limit buy orders should act as a buffer if price approaches the prior swing low.



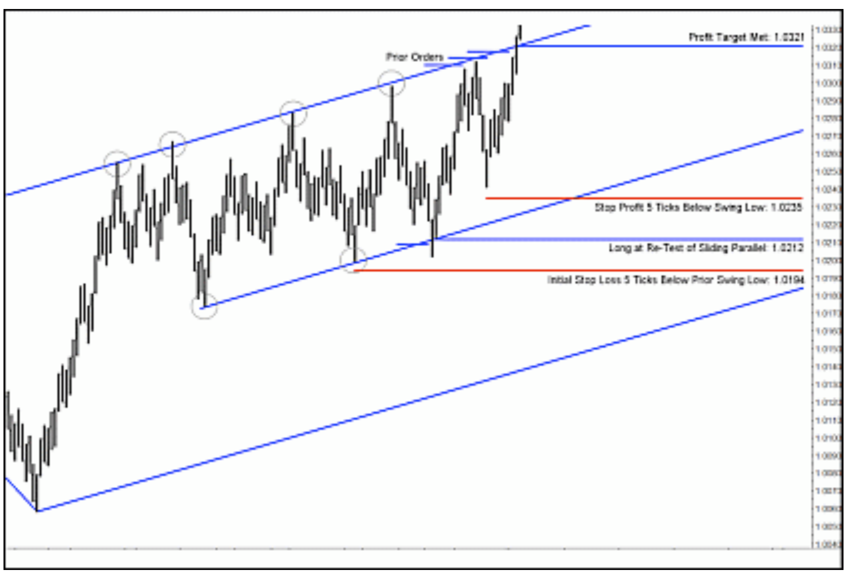
Looking at the chart above, I have identified an area that meets my requirements:

1. I want to go long at a re-test of the Sliding Parallel at 1.0209
2. My initial stop loss order is five ticks below the prior swing low, at 1.0194. There should be a good amount of limit buy entry orders at the or near the prior swing low that if I leave my order five ticks below the prior low, I'll be "protected" by the buy orders.
3. In this case, I am willing to take my profit at a test of the Median Line, because so far, price has been unable to break above it in four attempts. If I manage to get long and then find a higher swing low to hide a stop profit order underneath, I can always try to "catch a ride" once I am playing with the market's money. But for now, I would be very happy if I got long at the Sliding Parallel and then was able to sell it at the Median Line—which means I would have successfully traded the entire depth of this sloped trading range.
4. I am risking 15 ticks to make a potential 100 ticks, which gives this potential trade a very nice 6.7 risk:reward ratio.

Let's see what the market has in store for me!



Price came down several bars later and filled my limit buy order several bars later. Note that because the Sliding Parallel was sloped, I had to move my order a tick or two higher each time a bar closed. But I finally got long at 1.0212, and as you can see, price gave me quite a ride—just as bumpy a ride as the break out traders got, but my position was never at a loss. Price approached the Median Line where I had my profit order, but it didn't quite make it high enough to fill my limit sell order. Price backed off about 65 ticks before leaving a "V" bottom, then traded higher, making the "V" bottom a swing low. Once price climbed high enough to confirm the new swing low, I cancelled my initial stop loss order at 1.0194 and replaced it with a stop profit order five ticks below the new swing low, at 1.0235. I am playing with the market's money now, so my job becomes to concentrate on managing the position.



Price finally takes off to the up side, filling my limit sell order at 1.0321. Note that I moved my limit sell order several times, because I was long against an up sloping line—this means I was trading with the trend. It also means that as price moves further to the right, as I am in the trade longer, I must get paid more for keeping my capital exposed longer.

I hope you were able to see clearly through my eyes. It's funny how a few sloped lines can change the way you look at a market formation. I hope you can see now why I favor this style of trading over methods like break out trading.

I wish you all good trading.

Best,

Timothy Morge

timmorge@gmail.com
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