Trading According to Plan

How do you actually trade according to plan? Trading systematically means far more than merely setting stop prices or following technical chart signals. For a trading plan to work long term, it is necessary to know and consistently exploit your own edge when competing with other market participants. Professional trader Simon Betschinger shows us in this article how a theory about the workings of financial markets will first lead to specific trading strategies which can subsequently be integrated into a complete trading plan.

» This article is divided into two parts:

1. Recognising your trading edge
2. Suitable strategies for your trading plan

Part 1: Recognise Your Trading Edge

The Scramble for Yield

There is never-ending competition in financial markets between intelligent and financially strong players all of whom share the single goal of making money. If we want to give these people a face – and we are exaggerating a bit here – then it is the most talented mathematicians from Princeton who, together with the smartest physicists from Stanford and top-tier Harvard graduates, gathered in the trading department of an investment bank or hedge fund, devoting all their creative willpower to solving the financial-market puzzle. This competition is bound to lead to the profitability of recurring trading patterns being destroyed. The following example explains why this is. Suppose a classic breakout to a 20-day high had a positive expected value. In that case, financially strong market participants would position themselves right before the breakout signal and sell their shares again as soon as the actual signal is triggered and other traders jump on the bandwagon. Sooner or later, this race for yield will destroy any profitable trading pattern emerging from the data series. Anyone who claims that the opposite is true should be able to come up with appropriate trading results to prove their point, otherwise such a claim will, soon enough be debunked as a simple lack of understanding.

Random-Walk Markets

The consequences of this competition are obvious. If we tried to trade one of the major markets such as EUR/USD

on the basis of chart patterns without taking into account any additional information, we might as well be competing against Usain Bolt in the 100-metre dash. Our chances of success are the same in either case. Throughout the world, the most powerful financial-market players are busy studying the EUR/USD. There is no such thing as a personal edge here. Each profitable pattern that one might find via backtests and infinite attempts at optimising a system, is subject to a half life that is less than the time it would take a system trader to really work profitably with such a pattern. So when it comes to trading an index or a currency pair, you will be competing in undoubtedly efficient markets and Eugene Fama's famous conclusion that we are dealing with a random walk here, proves true. Disambiguation: The random-walk theory says that the courses of stock prices only can be described by random processes.

F1) Lonely Warrior Signal

It's not often that candles are formed completely outside the Bollinger bands. This is frequently an indication that there is an unjustified exaggeration and a backlash is imminent.

Source: www.traderfox.de

Why You Still Have a Chance

The one way of winning the game is to shift the competition to situations that are not covered by all the statisticians with their sophisticated software systems. The first move is headed towards equity markets, which resemble a zoom-in on details. You'll be leaving the level of anonymity and will raise the curtain on a play that includes a wide variety of characters who breathe life into the stock market. No computer program in the world can make a judgment on whether, for example, the latest Samsung Galaxy phone has the potential for competing with the iPhone. However, human beings can. They can form an opinion and wait for situations where the market and their own opinion are in complete sync. This means that the stock is developing exactly according to its own price scenario. These are the moments where you should be following the trends in an aggressive and determined manner. The second move is to trade whenever the trading algorithms of statistical traders pause to adapt to new circumstances. That is the case, for example, right after any explosive news that suspends all the statistical rules of behaviour in one fell swoop. Or whenever prices move away from the statistical norm.

F2) Expansion Down Gap

If right at the start of trading there is selling pressure in the market and significant price losses have occurred in advance, this is often an indication of irrational and emotional behaviour on the part of other market participants.

Source: www.traderfox.de

Being Thrown off Balance

Analysts are good at evaluating long-standing business models. However, their judgment is regularly flawed when it comes to capturing disruptive changes. Whenever the financial markets are hit by new information that describes a drastic change – be it, in the simplest of cases, significant changes in sales and earnings forecasts – market equilibrium will be upset for a short period of time. The chains that had made it a slave of the market will be cast off the stock. The new equilibrium will not be found immediately. There will be rapid price movements and a perceptible sense of general uncertainty. It may take several weeks for the stock to be revaluated and the laws of capital-market theory to be applicable again. Such sudden changes in the calculation bases are an opportunity for attentive traders who want to gain an advantage.

Let's stay with the stock markets. Even stocks with market valuations in the billions are not yet subject to a hundred per cent market efficiency where each player and each individual decision vanishes in the statistical background noise made by thousands of decision-making processes. In individual stocks, the fundamental data-based decision of a fund or large investor to stock up on positions may lead to noticeable price changes. A stock's relevant information base is also much wider than, for example, in the case of an index. The euphoric coverage of a revolutionary technology may lure thousands of traders into the stocks of a particular sector. No computer is capable of recognising the complexity inherent in the fact that it is sometimes many small traders who fall victim to a fallacy. Astute traders are quite capable of doing just that – and that's exactly why they have an edge over statistical traders. By reading stock-market reports the former realise, for example, that an expansion 52-week high was triggered by nothing but unrealistic expectations. And at that very moment, the risk/reward profile will shift away from the expected value of a roulette game towards an edge that can be exploited for a short period of time.

What Makes the Best Traders so Successful?

It's one thing to make money in the markets, it's another thing to comprehend why. We know traders who are very successful but who find it infinitely difficult to explain their strategy. It has taken the writer of this article a long time to understand exactly what his edge is. For most of the trading day you sit in front of the ticker and spend your time watching prices. The trigger for a trade is then usually a well-known behavioural pattern that you can eventually narrow down and describe. Traders arrive at experiential data by observing recurrent patterns and learning what happens subsequently. If this pattern then occurs again, the experiential data can be accessed and implemented.

A pattern may be much more than just a technical chart formation. It may include a huge amount of information such as corporate development, developing news, overall market situation, currency movements, and so on. And this results in what accounts for successful trading: Actually, as a trader you will just wait for patterns that you know inside and out to be working well. In the simplest of cases, such a pattern is, for example, a new 52-week high, a simple trend-following signal. It does not work throughout the entire year, but does an excellent job on an estimated 20 per cent of all trading days. For practical trading, that means analysing whether follow-up purchases are increasingly made after new highs or whether the breakout movement peters out. If the bottom line is that there is market sentiment that rewards breakouts to new highs with further price gains, you will buy this pattern as a trader. If not, you just won't.

F3) Momentum High

A momentum high break is the break of a distinctive point in the chart, which is the focus of many traders.

Source: www.traderfox.de

How Profitable Signals Keep Destroying Themselves

The profitability of patterns in the stock markets is subject to an evolutionary process that follows the rules of the efficient markets hypothesis. It starts with a pattern achieving an excess return in a conspicuous manner. For example, breakouts to new highs are accompanied by strong follow-up profits. This excess return will be observed by more and more market participants who then begin to trade this pattern. Initially, this may even enhance profitability, but eventually the trend will be reversed.

There are two adjustment processes here. First, too many traders who want to achieve short term gains, have opened positions upon the emergence of the pattern. The excess return starts to shrink and the gains that have been made on the basis of this pattern will be realised even earlier. Secondly, some market participants will very soon identify the trigger for the pattern marking the beginning of the excess-return phase. Market participants will then naturally anticipate this signal in advance, that is systematically accumulate a stock one per cent before the breakout to a 52-week high only to sell the shares again immediately. This evolutionary behaviour pattern of chart signals and more complex trading patterns explains, on the one hand, the nature of efficient markets. On the other hand, it serves to open a door: Those who are the first to understand which trading patterns are currently working well, can use this knowledge edge for a short period of time to systematically trade patterns with a temporary excess return before other market participants anticipate and destroy such.

Insights for the Trading Plan

The profitability of trading patterns is comparable to an evolutionary process. You need to have the opportunity to conduct a statistical evaluation that can first clearly identify patterns and, secondly, immediately alert you as soon as a positive expected value is developing. The trading patterns that are evaluated need to represent distinctive situations from which significant changes have emerged in the past.

Part 2: Suitable Strategies for Your Trading Plan

Lonely Warrior (Short Version)

This trading signal has a history that is easy to remember. A warrior who has strayed too far from his own lines, at some point finds himself alone and abandoned in enemy territory and sees his chances of surviving the enemy attack on his own dwindle rapidly. He has no choice but to let himself fall back until his own troops have caught up with him again.

Applied to the stock markets, the enemy territory is defined as the price territory outside the Bollinger bands. The Bollinger bands do an excellent job here to indicate whether prices move abnormally high or low. The signal "Lonely Warrior" requires that a complete candle was formed above the Bollinger bands or – this is the second version of the signal – that 90 per cent of a candle with a trading range of more than three per cent was formed above the Bollinger bands. This candle is then the lonely warrior that the trading signal owes its name to.

The short position will be opened the following day, once prices have fallen below the day's low of the "Lonely Warrior" candle. This risk tolerance for the trading position should be set at a relatively narrow range between two and four per cent. If a stock continues to rise despite this strong overbought condition, that usually indicates a systematic accumulation, which could possibly have fundamental reasons.

F4) Expansion 52-Week High

An expansion 52-week high is no ordinary 52-week high. It is a high that was formed in the wake of a strong short term price expansion.

Source: www.traderfox.de

Exact Rules Governing the Lonely Warrior Short Signal

1. Yesterday a complete candle was formed above the Bollinger bands. Alternatively, a candle was formed with a trading range of more than three per cent with 90 per cent of the prices being outside the Bollinger bands.
2. The signal trigger is yesterday's daily low. Once the price falls below the low, a short position will be opened.
3. The trade has a stop with a small risk tolerance of two to four per cent.

Expansion Down Gap (Long Version)

Emotions are rarely a good counsel when making trading decisions. In other words, if a wild herd of panicky market players give away their shares, that will be the right time to enter. Panic is an emotion that needs to mature on the stock market. It is like a good meal that only reaches its full flavour after a long period of simmering. At the beginning of a price panic there are usually moderate losses. These will then be more severe, and at some point there will be a double-digit loss on the books within very few days, which makes shareholders incredibly nervous and causes them to make irrational decisions. In terms of our signal, the irrational decision is the unlimited sale right at the start of trading.

Translated into technical analysis, this results in the criterion that the share price must have fallen sharply within a short period of time. More precisely, the prerequisite for the expansion down gap signal is that the price loss of the last five trading days is greater than three ATRs. If this downward-movement criterion is met, one will have to wait and see whether there is a supply overhang right at the opening of the next trading day or whether there is a down gap. Such a supply overhang could be an important indication of emotions, that is irrational actions. That will be the right time to open a long position. Prior to that, it is absolutely necessary for the news ticker to be checked. If there is any bad news such as a profit warning, for example, it will be better to refrain from opening a position.

Exact Rules Governing the Expansion Down Gap Long Signal

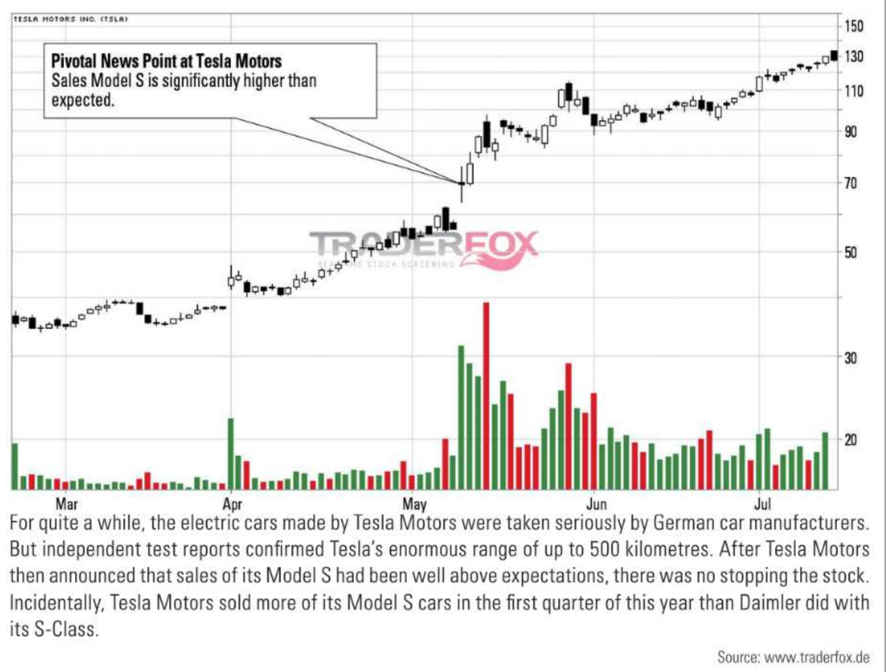
1. On the last five trading days, the stock's share price lost more than three ATRs.
2. Today, a supply overhang weighs on the stock right at the opening. The stock opens with a loss of more than 1.5 per cent.
3. If there isn't any extremely bad news (for example hefty profit warning), a long position will be entered immediately after the opening.
4. The long position is given a risk tolerance of two to four per cent.

Momentum High Break (Long Version)

There are certain points in a chart that almost every trader keeps an eye on. These certainly include the local highs or local lows that are V-shaped. Many traders place their stops at such prominent points or buy pro-cyclically into a position – quite in the spirit of the classical literature on such charts. Any experienced trader will often have had the experience of prices just once – for a tiny fraction of time – taking out such a point as described above only to then move in the opposite direction. This kind of price behaviour is no accident. It is the outcome of a market process that lets as many market participants as possible go the way of the worst pain.

"Place stop-loss orders!" That's what everybody keeps preaching all day long – in stock-market magazines,

F5) Pivotal News Point at Tesla Motors



For quite a while, the electric cars made by Tesla Motors were taken seriously by German car manufacturers. But independent test reports confirmed Tesla's enormous range of up to 500 kilometres. After Tesla Motors then announced that sales of its Model S had been well above expectations, there was no stopping the stock. Incidentally, Tesla Motors sold more of its Model S cars in the first quarter of this year than Daimler did with its S-Class.

Source: www.traderfox.de

in broker webinars, and in trading literature. Of course, minimising risk is a core component of successful trading. In practical reality, wrongly placed stop-loss orders are the main reason why many traders are unsuccessful. Those who set their stop prices in such a way that they are triggered by the everyday, random price noise, might as well go to the casino. Whoever places their stop-loss orders at distinctive points in the chart which virtually all traders are watching, is playing the part of a herring just waiting to be eaten by a shark on the prowl. After all, it is as plain as day that hedge funds or institutional traders will start testing a distinctive point in the chart if it can be assumed that that will be followed right away by automated and unlimited orders.

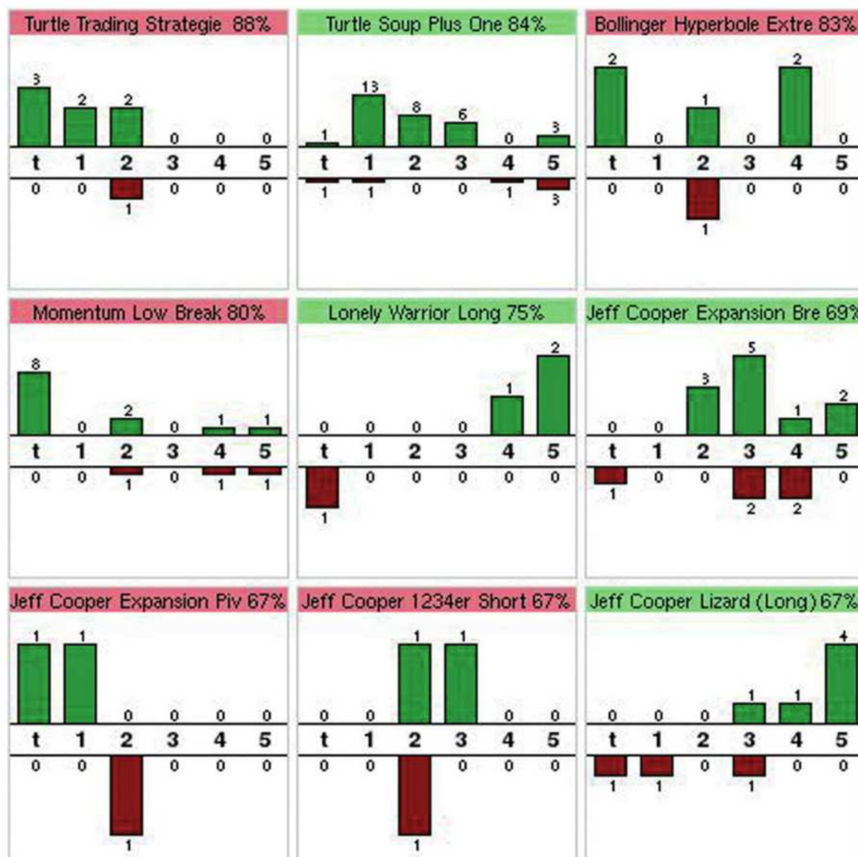
The "momentum high" chart pattern is defined as a local high that stands out, V-shaped, from the price performance. To ensure the V-shape, it is assumed that in the five days prior to the momentum high, there was an increase of at least 2.5 ATRs and in the five days after the momentum, prices must have fallen by at least two ATRs. If such a momentum high is broken, there is the signal "high momentum break" there. It is not a signal that should trigger an automatic trading reflex in a trader. Rather, it is a stock screening which provides interesting charts and prompts you to get to the bottom of the cause of the price movement. If the price increase leading to the momentum high break was triggered by good corporate news, the signal should rather be traded long. If, however, the price increase is purely driven by recommendations, industry strength or traders, a counter-cyclical positioning is a good choice.

Real-time hit rates also are a good guide in determining whether the market currently favours cyclical breaks.

Exact Rules Governing the Momentum High Break

1. A momentum high was formed in the last eight weeks. There will be such a "high" if in the five days prior to the "high" an increase of at least 2.5 ATRs occurred and in the five days after it there has been a price slump of at least two ATRs.
2. Today this momentum high is broken.

F6) Real-Time Hit Rates



Real-time hit rates are a tool that informs traders about which signals currently work well on the market.

Source: www.traderfox.de

Expansion 52-Week High

A new 52-week high is the standard signal of every trend-following trader – and rightly so because there is no doubt that it shows that the bullish forces in the corresponding stock are strong. Any stock whose value goes up dramatically, is bound to go from one 52-week high to another 52-week high in its inexorable upward movement. A trivial insight? Not necessarily, if one draws the right conclusion. Anybody watching all stocks on a daily basis that have advanced to a new 52-week high, can be sure to have all the future hot stocks (those whose prices keep soaring) on their radar. It is important now to identify those stocks where the new high might be the technical precursor of a fundamental revaluation process – much like prior to a tsunami the water will recede once more before forming that big towering wave.

The "expansion 52-week high" is no ordinary 52-week high but

one that is accompanied by strong price momentum. We are looking for situations in the chart that show a strong rally momentum in the immediate run-up to a new 52-week high. It is as though the chart is screaming, "Look here, there is something happening here." If screened for on a daily basis, the chart pattern only occurs for a small number of stocks. These are the ones that are worth doing more in-depth research on. In particular, the question should be raised whether the strong momentum is triggered by pivotal news or a euphoric sentiment in a particular sector. In the latter case, counter-cyclical positioning might be promising. If corporate news was published, downright forcing a revaluation potential, a long position will be the logical conclusion.

Exact Rules Governing the Expansion 52-Week High

1. Today, a new 52-week high is reached.
2. The price increase for one day is greater than 1.4 ATRs. **Or:** The price increase since two days ago is greater than 2.4 ATRs. **Or:** The price increase since three days ago is greater than three ATRs.

Pivotal News Point

Contrary to all the nonsensical claims usually made by market players worldwide who have just been taught a bitter lesson by Mr Market, stock quotes have, in the long run, always something to do with the fundamental development of the company. Share prices will follow the trend of corporate profits, and from a long term perspective market values originate on a par with increased profitability. It is no coincidence that many strong upward trends are initiated after the publication of company news.

Whenever breaking news is thrown into the market system, this sets into motion a chain of decision-making processes to be engaged in by market players. Will the new realities match our own expectations? If not, trades will be made. An increase in the earnings forecasts, for example, may lead to an investment-fund analyst presenting his new target-price prediction at a meeting and the decision being made to build a significant position in the double-digit millions.

Whenever the new realities emerging after pivotal news pulverise long-held opinions and ideas, the capital-market players are deprived of their calculation bases. People and, more importantly, management structures in companies are such that opinions that have long been voiced cannot be revised overnight. When Apple's iPhone was launched and the first gigantic sales successes were achieved, most analysts probably suspected that Nokia's days were numbered for the time being. But virtually no analyst dared at the time to utter this insight immediately. It takes time for new realities to be accepted. This is shown in the stock markets in periods of strong outperformance or underperformance of shares following pivotal news.

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The Exact Rules Governing the Pivotal News Point

1. Today, a news item is published that at a stroke throws out the existing calculation bases regarding the future profits of a company and outlines a new development path that in this shape has not previously been considered possible by most market participants. The first price after publication of the news is the pivotal news point.
2. Buying starts immediately after the publication of the pivotal news.

Your Next Few Steps

You should take the time to think at length about whether, objectively speaking, you have an edge in the markets, and if so, what exactly it is. In the long term, this criterion is the basic prerequisite for success in the stock market. Thereafter, make a trading plan in which you explain your strategy in detail and respond to all contingencies in the form of scenarios — how to proceed when you are winning and how do you act in the event of a loss, what to do with surprising news, and what if there is a sudden market crash? Anything can happen in the markets, and you need to have a ready answer to everything. Otherwise, there is a danger of you having to respond at short notice, deciding emotionally, and making exactly the wrong decision in the heat of the moment (which other traders who are better prepared will benefit from). Professional market participants have worked intensively ahead of time to be prepared for all eventualities and when it matters know just what to do – and so should you. «