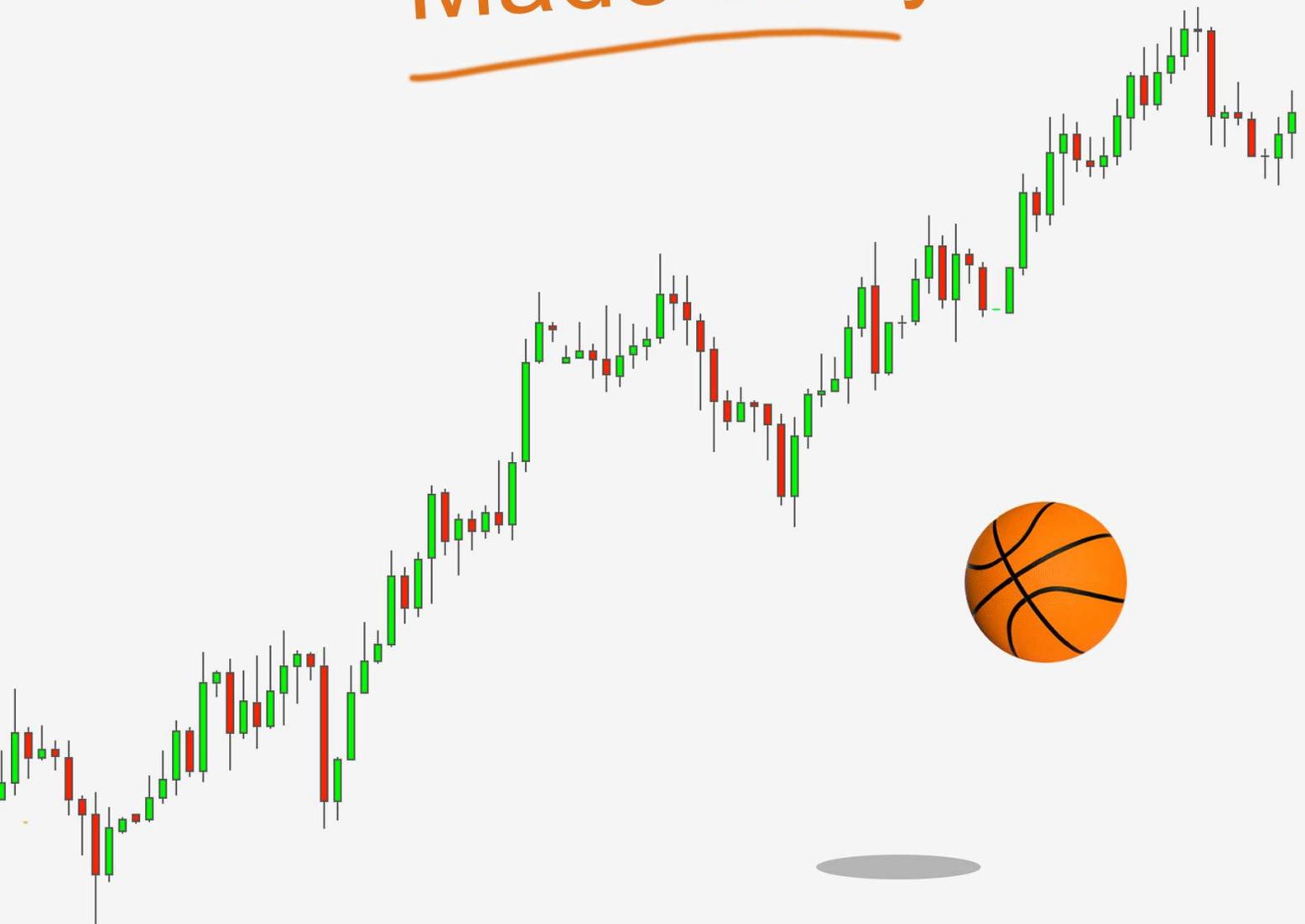




Practical Trend Trading

Made Easy





A Note From Chris

A lot has changed since my first e-book, *Candlesticks Made Easy* was published in 2008 (6 years ago!).

At the time, global market volatility shot up to all-time highs as the financial world reeled in the wake of the U.S. sub-prime crisis.

And now in 2014, volatility levels have retreated back to near record low levels never seen since 2007.

The chart below (VIX) illustrates the differing scales of volatility between the periods 2008 - 2012, and 2012 - 2014.



At the peak of the crisis, price volatility was 3 - 5 times higher than the volatility levels we're seeing now.

Put another way, the market volatility is now approximately 75% - 85% lower than it was 5 years ago.



Here's the EUR/USD chart comparing the same two periods:



For many traders, it's been a roller-coaster ride as financial markets around the world experienced dramatic shifts over the past few years.

In particular, fixed trading systems that worked well in the past suddenly suffered from a long string of losses.

"Why did my system stop working?" people asked.

Well, the thing about fixed systems is that they can only keep working if the nature of the market is fixed. The "problem", so to speak, is that the market never stays the same for long.

This is why, in this book, we'll focus on the practical philosophies and principles behind trend trading, rather than merely describing a fixed trading system based on technical indicators.

By understanding exactly *what* trend trading is and *how* it works (and *why*), you'll be able to keep trading well in the face of changing market circumstances.



Introduction

Successful chefs don't follow recipe books. In their head, they already have a deep understanding of each ingredient and what it tastes like when combined with other ingredients.

Put a dish in front of an expert chef, and he can mentally break it down into its components and modify the recipe. And if he's really good, he can create an entirely new dish with the same ingredients.

That's the level of market understanding I want you to attain after going through this book and practising its principles. My goal is for you to be able to look at any price chart, figure out what's going on, and be able to trade it effectively.

You won't be getting cookie-cut theories here, since that wouldn't be useful at the practical level. Instead, you'll be getting the tools to come up with your own answers, based on what the market "tells" you. It's this feedback loop that keeps you in touch with the ever-changing nature of the market.

Trading systems and styles come and go, and the only thing we can really count on is our ability to reason and think our way through the inevitable changes that will keep happening in the future.

Only by learning (and practising) how to identify and respond to these changes, can we avoid the traps so many others have fallen into, and continue thriving as traders.

In this sense, this book isn't about teaching you *what* to think, but *how* to think like a trader.



Note: Not For Beginners

To fully benefit from this book, you'll need a basic understanding of trading. If you don't know what a candlestick, moving average, or limit order is, this book is probably too advanced for you right now.

If you're new to Forex trading, check out the trading school at the Baby Pips website: babypips.com/school. There, you can pick up the basics of Forex trading, and come back here afterwards.

It will also be helpful if you already understand the concepts of momentum, rejection, reverse rejection, and anchor candles (that are covered in *Candlesticks Made Easy*). I won't be explaining these concepts and will assume you already know how they work.

Now let's get started.



Content vs Context

When we learn something new, we pick up two aspects about it: the content, and the context.

The content refers to factual information. It's about the *what*, *how* and *when*. This is what most people focus on.

For example, retail traders often rely on indicator-based systems for their trading decisions. The indicators supposedly tell them *what* the market is likely to do in the future and *when* that might happen. The system then tells them *how* they should trade that prediction.

There's no ambiguity involved with the content — the moving average lines have either crossed, or they haven't. The Stochastic Oscillator indicator is either in the overbought region, or it isn't. There is no grey area.

And since retail traders tend to come from technical/academic backgrounds, this is the area they are most comfortable with. They like dealing with precise questions, formulas and answers.

Unfortunately, financial markets (and indeed, human beings) do not operate within these parameters. There is no formula that can predict the aggregate outcome of human actions, especially when greed and fear are involved.

Now what about *context*?

Context is all about the *why*. It's about the meaning we assign to something. It's about the *way* we look at it. It's the subjective view.



For example, how would you feel about attending a class on advanced statistics? Some people would rather stab themselves in the eye, while others would pay good money to be there.

And therein lies the defining characteristic of *context*: the same information can mean very different things to different people. Two people with the same information can act in opposite ways because they have opposing views of it.

In this sense, two trend traders can take completely different actions at the same point in a price trend.

For example, look at this downtrend:



As a trend trader, what would you do in this situation?



Would you sell immediately? Or would you wait for a pullback?

Either option could be the right one, depending on your context (view) of trend trading.

Next, we see that prices did not move further down, nor did it make a pullback. Instead, it started to consolidate:



Now in this case, what would you do? Sell, or wait?



Next, we see prices start to move up:



Now what should you do? Sell, wait, or buy?

One trend trader might think that this is the end of the downtrend, and buy in anticipation of prices continuing to move upwards (in a new uptrend).

Another trend trader might think that the market is getting choppy and would prefer to stand on the sidelines.

Yet another trend trader might think that this “pullback” a good opportunity to add on to his short position and enter a new sell trade.



So which approach is the correct one?

The thing is, these traders could *all* be making the right decision.

You see, it depends on the *philosophy* behind their trading approach.

It depends on:

- How they define a trend
- What they think causes prices to move
- How they think prices tend to move
- Their trading time frame
- How they define the end of a trend
- Their risk-reward ratio
- ... among many other considerations

As long as the reasons for the trade are consistent with their trading philosophy, each one of those traders could be doing the “right” thing.

So although trend trading has often been talked about as a particular *way* of trading (that is, in the direction of the trend), in practice that distinction means little. There are simply too many different ways to be ‘trend trading’ for there to be any meaning in calling them the same thing.

Thus, what matters is the *context* in which we view ‘trend trading’, because that is what will determine *whether* we’ll enter a trade, *where* we’ll do so, *where* we’ll close it, and most importantly, *why* we choose to make each of those decisions.

Once you understand the context behind the *Practical Trend Trading* approach, you’ll naturally know what to do in all market situations.



Trend Trading Philosophy

The essence of trend trading is closely related to the only situation in which traders make money: when the market price moves.

If the market price did not move, traders would not exist.

In this sense, all traders rely on a price trend. Even counter-trend traders need a trend in order to trade in the opposite direction of it.

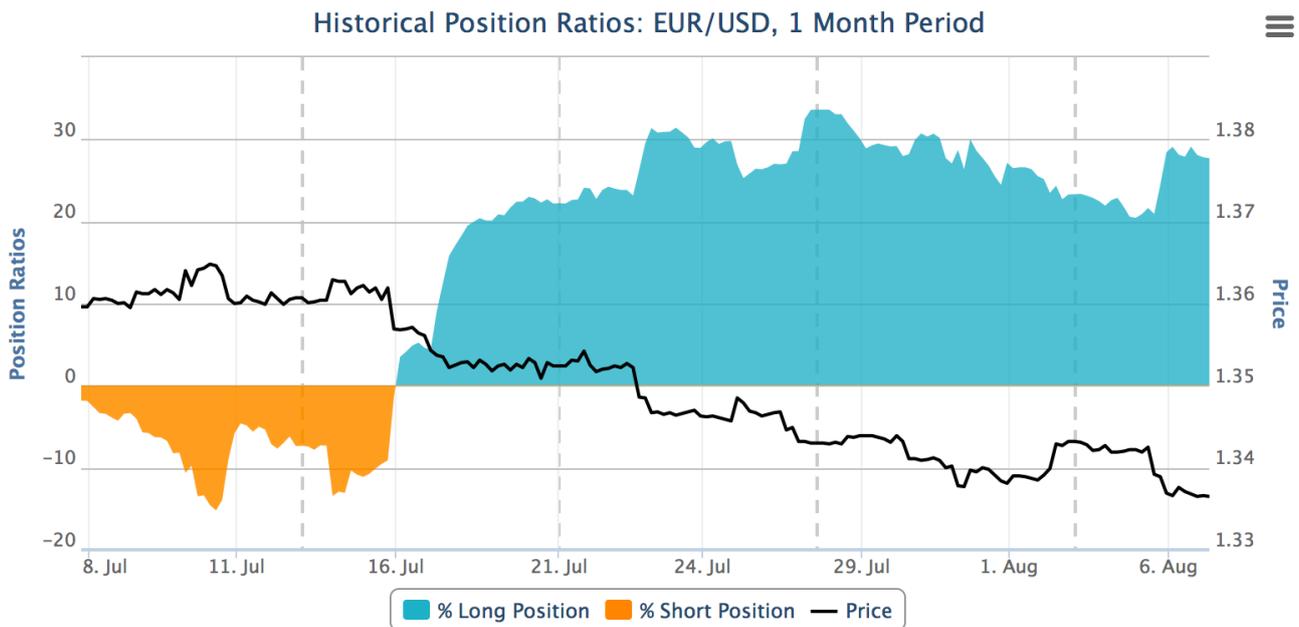
Thus, the only real difference between a trend trader and range trader (or counter-trend trader) is how long they expect the current trend to continue.

A trend trader might expect the trend to continue indefinitely (until it proves otherwise), while a range trader might expect the trend to reverse when it hits a support/resistance level.

It may be interesting to note that despite all the literature about the benefits of trend trading, the majority of retail traders' positions are still of the range/counter-trend variety.

How do I know this?

In recent years, retail brokers have released data about the holdings of their clients (retail traders) and the numbers almost always show that they buy as prices goes down, and sell as prices goes up.



from Oanda Corporation

In the graph above, the black line indicates the EUR/USD price over a 1 month period. The orange portion indicates the size of the net short positions, while the blue portion indicate the net long positions.

The graph gives us a snapshot of how the trade positions of traders changed over time. Notice that as the price (black line) moves down, retail traders tend to take (and hold onto) long positions.

And just in case you think this rarely happens, it doesn't. It happens almost all the time. See for yourself here:

<http://fxtrade.oanda.com/analysis/historical-positions>

The takeaway is that in spite of all the talk and discussion about trend trading, most traders simply don't do it.

Why?



Perhaps, it is due to a lack of discipline... but I believe the real reason to go deeper than that.

Allow me to explain by asking a question:

Do you need discipline to hold yourself back from touching a hot stove?

Hopefully, you answered 'no'.

You know very well the consequences of touching a hot stove, so it is only natural for you to avoid it. "Discipline" wouldn't be necessary.

In the same vein, I believe most retail traders are unable to stick to trend trading not because they are ill-disciplined, but because they don't have a clear, uncompromising understanding of why they should.

Thus, before we talk about anything else, we must first begin with the fundamental reasons behind trend trading.

What is trend trading exactly? And why should we stick to it?

We'll answer these questions (and more) in the next section.



Why Trend Trading?

So why should we focus on trend trading instead of range/counter-trend trading?

The short answer, is that a trend trading strategy is most likely to be the optimal one for retail traders.

You see, it boils down to how the retail trading industry is structured.

To succeed in any game (of which retail trading can be considered to be one), we'll first have to study the rules and their implications for the players involved.

Imagine a coin toss game where there's an equal chance for the coin to land on either side. In this game, we can either double our stake if we bet on the winning side, or lose our stake if we bet on the losing side.

In a game like this, we should probably choose not to play at all, since the profit expectation in the long run would be zero. This is often referred to as a zero sum game, where every \$1 lost by a player is won by another player.

However, this is not how retail trading is structured. Instead, it's a lot more like a card game at the casino, where the house takes a cut out of every game that's played.

This results in a different dynamic compared to the coin toss game, with the overall expectation here being negative — that is to say, that every \$1 lost by a player results in only a gain of \$0.90 to another player (with \$0.10 going to the broker/dealer).



So... as retail traders the first thing we have to be aware of is that the average profit expectation of the trading game is less than \$0 (i.e. worse than betting on a coin toss).

And, we'd also have to consider that the professional (institutional) traders in the market are faster, more well-informed and have a lot more capital to trade with, than we do.

This puts us at a significant disadvantage and everything else being equal, we'd probably get our asses kicked if we compete directly against them.

So even though our average profit expectation is less than \$0 (statistically speaking), in practice it is probably a *lot* lower than \$0.

At this point, you might be starting to feel a little discouraged about this whole trading business. If so, you're on the right track.

The reality is that retail traders tend to lose money because the industry is structured with the odds stacked against us. It's really that simple.

And this isn't even considering our tendency to self-sabotage by entering and exiting trades at exactly the wrong times, due to psychological biases.

Probabilistically speaking, we are are primed to lose in the long run.

That's the sobering fact you need to know if you want to get serious about trading.



And, as you might have guessed, the only way to make money in such an environment is to employ an approach with the best chance of tilting our profit expectation into positive territory.

How can we do this?

The answer lies not with trading from statistical (quantitative) approach, but from a *qualitative* one.

Trade Quantity vs Trade Quality

A quantitative trading approach benefits the party that has the odds in his favour.

For example, a casino has an approximate 3.5% advantage (positive expectation) over the players at the blackjack tables. With this statistical advantage, the main incentive of the casino is to get as many people to gamble as often as possible.

The casino owner doesn't care whether the house wins (or loses) at *each* round of blackjack, because he knows that the more people gamble, the more money he'll make over time.

This is also how trading brokers (market makers) operate. By charging a spread fee, they essentially tilt the odds of making a profit in their favour, and are incentivised to get their customers (retail traders) to trade as often as possible.



For retail traders however, a quantitative approach to trading is a losing game since we start out at a statistical disadvantage.

Thus, the only way for us to make money over the long run is to employ a *qualitative* trading approach.

Unlike a quantitative approach — in which we'd want to take as many trades as possible — **a qualitative approach involves being selective with our trades, and taking as few of them as possible.**

By limiting our trades to only the top quality ones, we reduce our exposure to the default odds that are stacked against us.

To explain this point, imagine the market to be a big box of mostly rotten apples, but with each apple being sold at an equally cheap price.

As traders, we are like the customer who has to close our eyes and rely only on our sense of touch to pick out the apples we want. Not all apples in the box are rotten, and there are some very good deals to be enjoyed if we are able to pick out the good apples.

The more times we dip our hands into the box, however, the more likely we are to pick out a rotten apple (after all, there are many more rotten apples than good ones).

Naturally, the savvy apple merchant wants us to pick as many apples as possible, since doing so would increase his chances of selling us the spoiled ones.



In the same way, our broker's incentives are inconsistent with ours. They want us to trade as much as possible, while we should be staying out of the market as much as possible.

The takeaway here is that **the more often we enter the market, the more likely we will lose in the long run.**

To Summarise...

With a quantitative approach to trading, the reason for each trade doesn't matter. The only thing that matters is the *number* of trades taken. The more trades, the better the chances of making money.

With a qualitative approach, the reason for each trade matters. When the average profit expectation is negative, the only way to make money is to take the few trades that are most likely to make money, and ignore all other (low quality) opportunities.

The key point is that we should trade with an approach that does not require us to take a large number of trades. And when we *do* take trade, we must be reasonably certain that there's a good chance of it being a winner.

The next section will further elaborate on these points.



Expected Value

In statistical theory, there's a concept called *expected value*.

It refers to the (theoretical) average result of an event, based on the probability and magnitude of each possible outcome.

The formula for expected return is one of the cornerstones of our trend trading approach. Let's take a look at its components:

$$(P_W \times A_W) + (P_L \times A_L)$$

P_W = Probability of winning

A_W = Winning amount

P_L = Probability of losing

A_L = Losing amount

To understand this formula, let's use the example of a coin toss. If we bet on 'heads' and win, we'll make \$100. But if we lose, we'll part with \$100.

Now, since there's a 50% chance for the coin to land on either side, the expected value of this game would be:

$$(50\% \text{ heads} \times \$100) + (50\% \text{ tails} \times -\$100)$$

...which can be expressed as:

$$(0.5 \times \$100) + (0.5 \times -\$100)$$

The answer to this equation is \$0, which is the expected value of this game.



This means that in the long run, we should expect to make \$0 (we'd just break even).

Now imagine playing the same game, but this time with a rigged coin that lands 'heads' up 55% of the time.

Our expected value of this game would be:

$$(0.55 \times \$100) + (0.45 \times -\$100) = \$10$$

Thus, in this rigged game we can expect to win an average of \$10 over time.

Of course, we will never actually make \$10 since our final result must be a multiple of \$100 (we can only win or lose \$100 each time).

However, the benefit of the expected value formula is that it helps us think objectively about the relationship between probabilities, payoffs and the expected result.

Let me explain further: which of the following bets should you take?

1. A 55% chance to win \$100, and a 45% chance to lose \$100; or
2. A 40% chance to win \$140, and a 60% chance to lose \$70?

Intuitively, the answer might not be clear.

But if we apply the expected value formula, we know that these bets yield an expected value of \$10 and \$14 respectively... so we should take the second bet!

Now what has this got to do with trading?



Well, let's consider the fundamental assumption of trend trading: Prices are more likely to move in the direction of the trend than against it.

This means that everything else being equal, the chances of winning a trend trade is likely to be greater than 50%.

But since there's no way to tell the exact probability of winning, let's be conservative and assume a 51% chance.

Using the expected value formula, we get:

$$(0.51 \times A_W) + (0.49 \times A_L)$$

Now what does equation this tell us?

It tells us that if the winning amount (A_W) is *at least equal* to the losing amount (A_L), we'll end up with a positive result.

For example, if each trend trade will either profit us \$100 or lose us \$100, this is what the equation will look like:

$$(0.51 \times \$100) + (0.49 \times -\$100) = \mathbf{\$2}$$

In this example, we'd end up with a positive expected value of \$2.



At this point, it would be appropriate for me to clarify that is only meant to be a philosophical concept. After all, there is no way to know the actual expected value of trend trading, since (unlike a coin toss game) the limits of price trends cannot be defined.

The expected value formula simply serves as a mental framework to help us think about how the *probability* of winning relates to the winning *amount* to yield the expected result.

Now what if we trade with a better risk-reward ratio, where each trade would either profit us \$150, or lose us \$100? In other words, with a risk-reward ratio of 1:1.5?

Here's the equation for this scenario:

$$(0.51 \times \$150) + (0.49 \times -\$100) = \mathbf{\$27.50}$$

Do you notice something here?

With just a 50% improvement in the risk-reward ratio, the expected value increases *over 1,300%* !

And all this with just a 2% higher chance of winning over losing. With practice, our winning percentage can certainly improve.

Ultimately, **our trading results will be determined by the *winning percentage* and the *risk-reward ratio***, which is expressed by this formula.



This is the crux of why we will focus on trend trading. It gives us the best chance of winning trades (more than 50%), and with a better risk-reward ratio (i.e. better than 1:1).

This is how we can succeed as retail traders even though we start out at a statistical disadvantage.

As we go through the coming chapters, keep this philosophy in mind and things will quickly make sense.



Basic Trend Framework

A common indicator used to identify price trends is the moving average line. This is not a beginners book so I'll assume you are familiar with how it is calculated and how it works.

The thing about the moving average line is that it's a lagging indicator, which is why we won't be using it to determine our trade entries or exits.

Instead, we'll use it as a **secondary tool to remind us of the overall strength and direction of an ongoing trend.**

We can use any period setting that isn't too short (less than 30) or too long (more than 50). The reason for this is because we want a moving average line that's relatively stable while at the same time not lagging too far behind the market price.

Personally, I like the **40 period simple moving average (40SMA)**.

The 40SMA will remind us of the *direction* of the trend (based on whether it's moving up or down), and the *strength* of the trend (based on how steep the line is).

Let's go through an example to see how this is done.



In the chart above, prices are clearly in a downtrend.

However, there might be more to this trend than meets the eye.

Let's now add the 40SMA indicator to the chart and see what we find.



Looking at the *slope* of the 40SMA, we can tell that the downtrend is slowing down — it is losing momentum.

This information will be helpful if we're thinking about entering a new trade, or closing an existing one.

Later on, in combination with what we'll learn about the wave and trend structures, the moving average line will help us assess the overall "health" of an ongoing trend.

Moving on, let's examine the basic components of a price trend.



Waves, Peaks & Valleys

When prices trend, they tend to move in a zigzag manner called "waves".

The best way to understand this is with an example. Below is a basic candlestick chart of an uptrend:



If you notice, these price movements can be separated into distinct "up" and "down" sections.

The next image shows the same price chart, but with an emphasis on the waves.



By (mentally) simplifying a price chart into waves, we can better visualise the characteristics of the trend we're looking at.

But before we get into that, let's first take a closer look at each individual wave.

In a price trend, there are two types of waves: impulse and pullback waves.



Impulse waves are waves that move in the direction of the trend. They are typically larger (i.e. longer) than pullback waves.

Pullback waves are waves that move in the opposite direction of the trend. They are typically smaller than impulse waves, and are sometimes called *correction waves*.

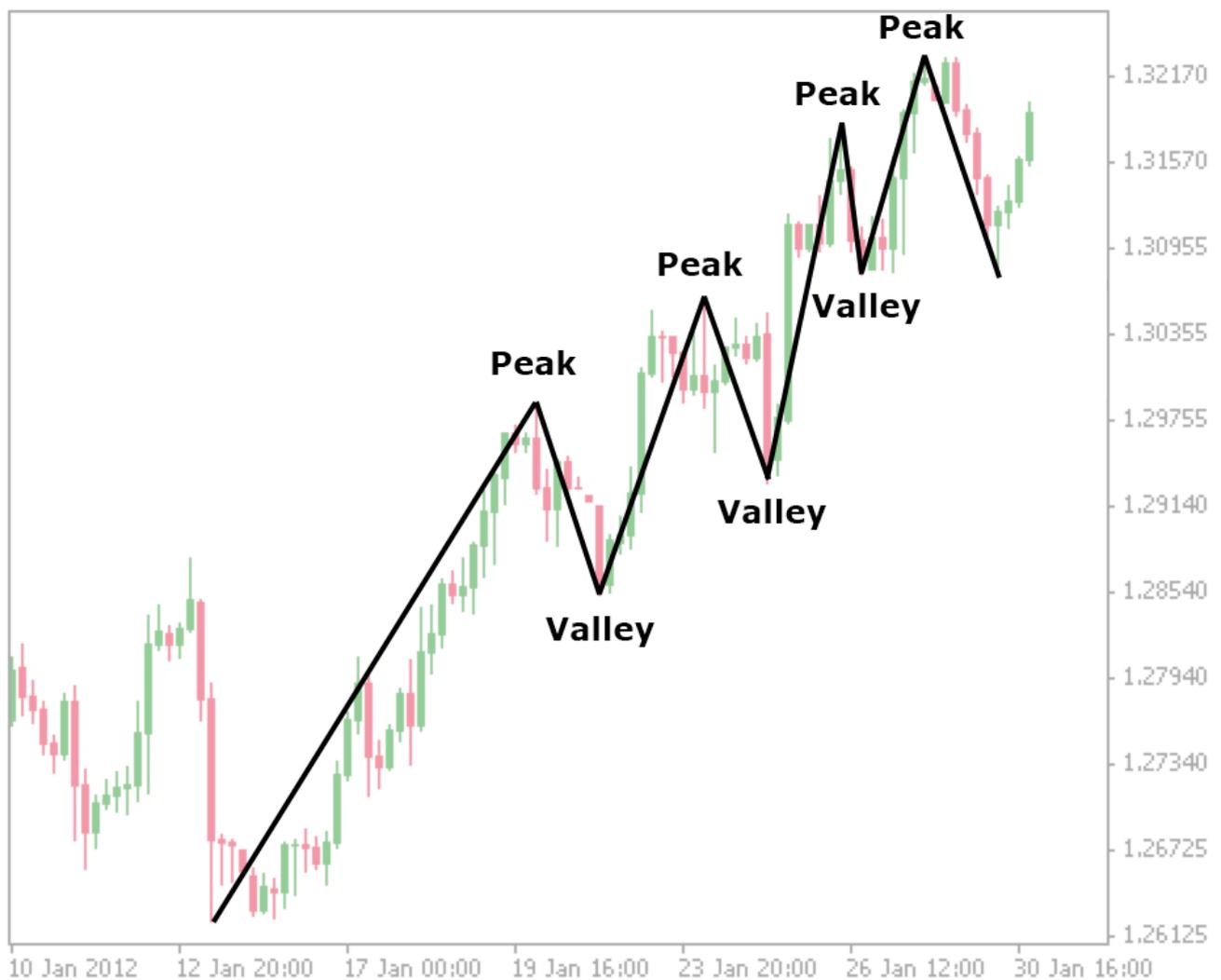
An impulse wave will always be followed by a pullback wave, and vice versa.





The points where an impulse and pullback wave meets is either called a *peak* or a *valley*.

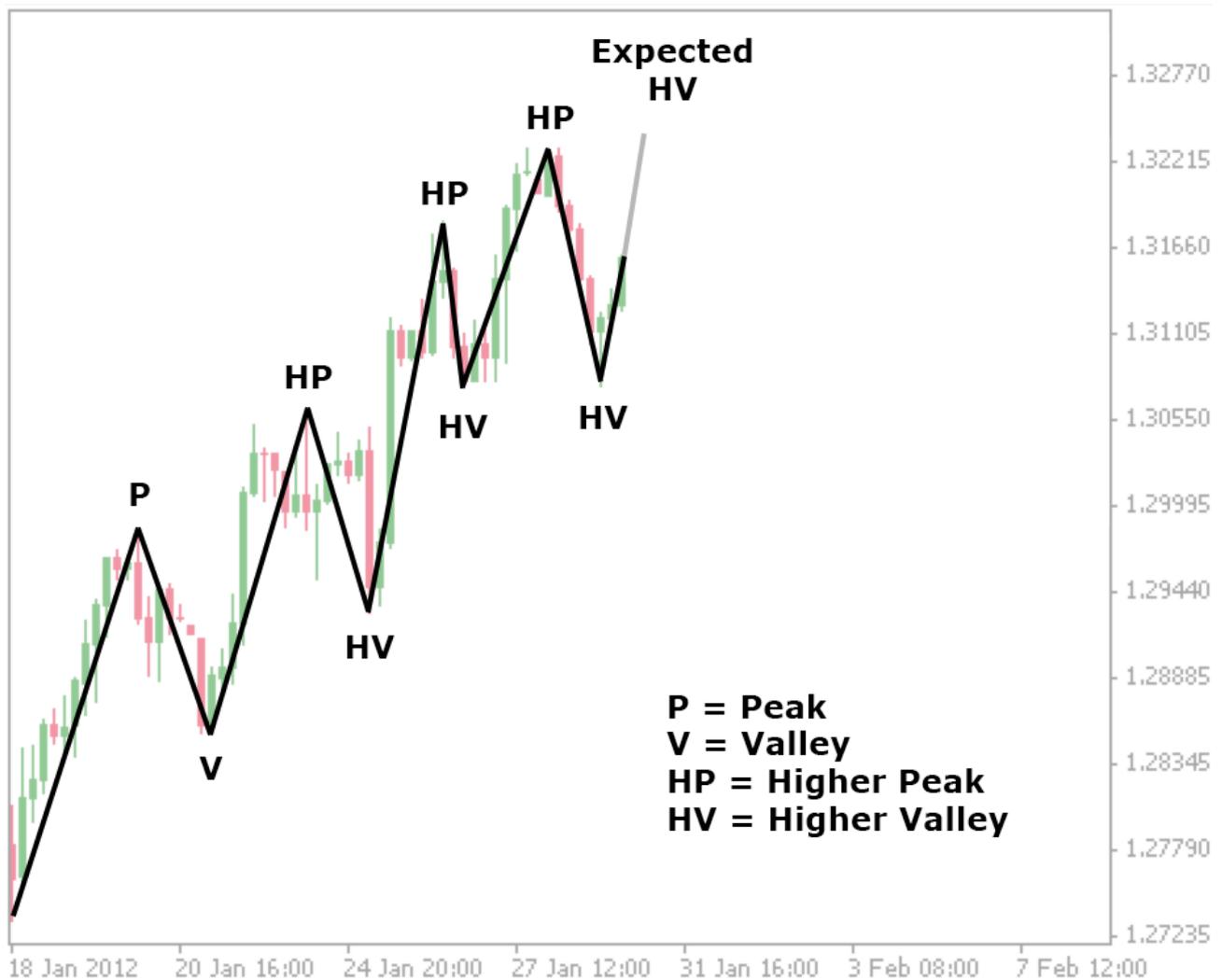
A **peak** is the point where an up-moving wave meets a down-moving wave, while a **valley** is the point where a down-moving wave meets an up-moving wave.





When prices are trending up, we'll expect to see consecutive higher peaks and higher valleys.

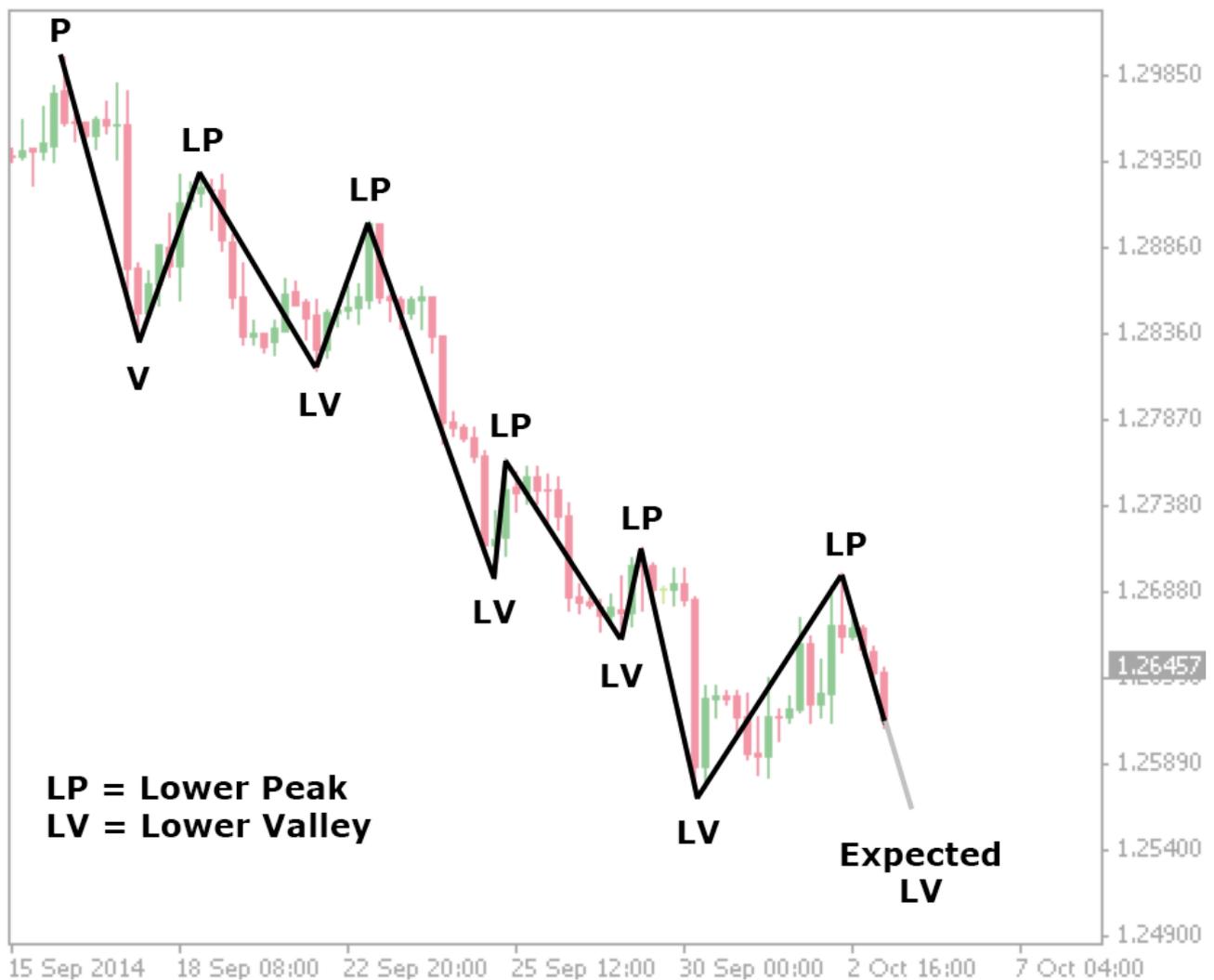
A higher peak refers to a peak that's higher than the previous peak, and a higher valley refers to a valley that's higher than the previous valley.





Similarly, when prices are trending down, we'll expect to see consecutive lower peaks and lower valleys.

A lower peak refers to a peak that's lower than the previous peak, and a lower valley refers to a valley that's lower than the previous valley.





End Of The Trend

For our purposes, a trend is considered to be over when:

- Prices move below the latest valley in an uptrend; or when
- Prices move above the latest peak in a downtrend.

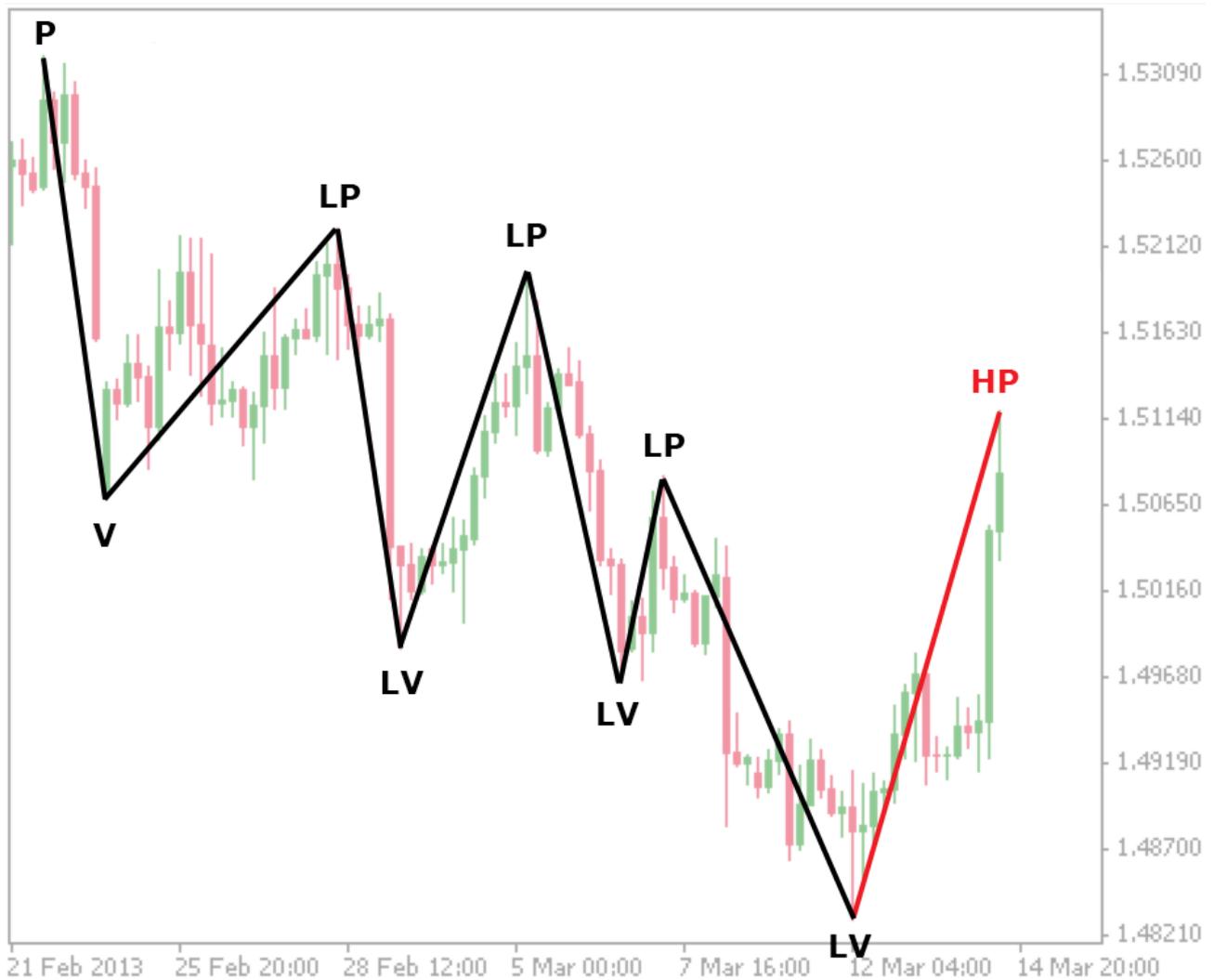
End of Uptrend



In an uptrend, we should only see consecutively higher valleys. So the moment we see a lower valley, we consider the uptrend to be over.



End of Downtrend



In a downtrend, we should only see consecutively lower peaks. so the moment we see a higher peak, the market is telling us that the trend is over.

When the trend ends, we will no longer be looking to trade in that market until it starts trending again.



Wave Strength

Impulse and pullback waves come in a variety of forms, but they can generally be classified as 'strong' or 'weak'.

The strength of a wave is determined by the **number of pips moved**, and the **time it took** to do so.

The further and faster the wave moves, the stronger it is.

To illustrate, here's a basic candlestick chart:





Now let's take a look at the strength of each impulse wave:





Now let's examine the strength of each pullback wave:



In general, the stronger the impulse waves and the weaker the pullback waves, the more likely the trend will continue.

In a later chapter, we'll examine this topic in further detail.

For now, we'll move on to examine the basic types of pullback waves.



Pullback Wave Types

There are 3 basic types of pullback waves:

1. Type A pullback wave
2. Type B pullback wave
3. Type C pullback wave

Each pullback wave type corresponds to the *extent* of the pullback in relation to the impulse wave.

Type A Pullback

A Type A pullback is one that does *not* move back to the **halfway** point of the impulse wave. In trader-speak, we say that prices did not reach the 50% pullback level.





Type A Pullback Example (uptrend)





Type A Pullback Example (downtrend)

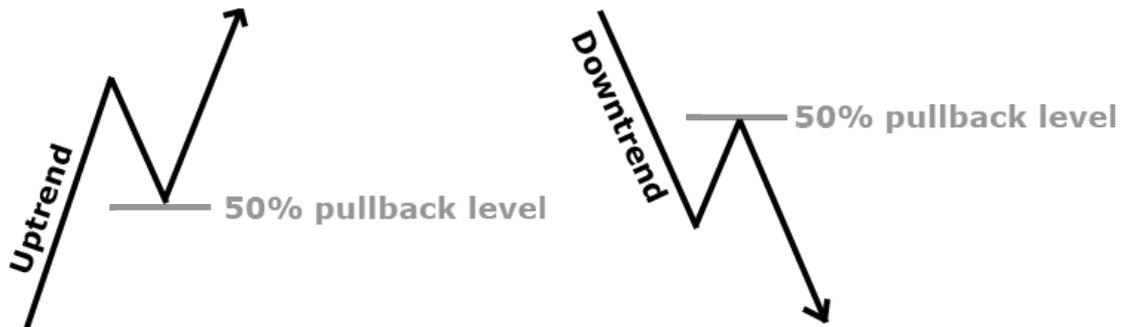


Type A pullbacks are the weakest among the 3 types. They typically occur when the price trend is strong.



Type B Pullback

A Type B pullback is one that moves to approximately the halfway point of the impulse wave.



Type B Pullback Example (uptrend)





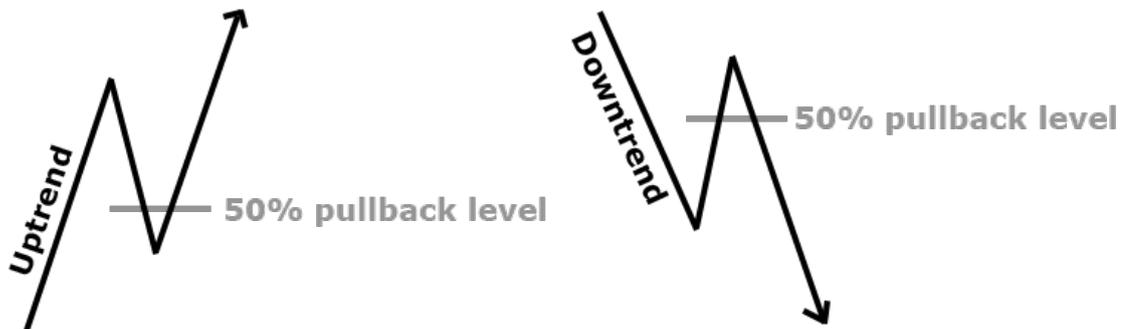
Type B Pullback Example (downtrend)





Type C Pullback

A Type C pullback is one that moves significantly beyond the halfway point of the impulse wave.



Type C Pullback Example (uptrend)





Type C Pullback Example (downtrend)



Type C pullbacks are the strongest among the 3 types. They typically occur when the price trend is weak.

The rule of thumb regarding pullback waves is: **the stronger pullback waves, the weaker the trend.**

By the way, these wave pullback types are only observable in hindsight. We can never know in advance how far an ongoing pullback will go until it's over. Thus, this concept is only applicable in assessing pullback waves that have already happened. Nonetheless, this is a useful way to judge the overall quality of an ongoing trend.



Entry Philosophy

This chapter explains where we will enter our trades, and why. This is typically a favoured topic among traders, as it is the most exciting one to talk about.

However, if we truly understand of the philosophies behind trend trading, the trade entry method would pretty much select itself — we wouldn't be left with much of a choice.

Let's begin by considering the *limits* of our knowledge.

What *can't* we know about trend trading?

We can't know for sure:

- *If* the trend will continue
- *When* the trend will continue
- *How far* (and for how long) the trend will continue

Well then... what *can* we know for certain about trend trading?

The only thing we know for sure, is that **we want to get out of the market the moment the trend is over.**

In other words, as soon as the trend ends, there is no longer any reason to keep a trade open, and we should close it immediately.



Recall: The default trading odds are stacked against us. The longer we stay in the market, the more we are exposed those odds.

Our trade entry will thus be based on the one thing we know for sure: where we'll definitely close the trade when the trend ends.

In this sense, our trade entry will be paradoxically determined by our predetermined trade exit.

How would this work?

Let's revisit the expected value formula:

$$\text{Result} = (0.51 \times A_W) + (0.49 \times A_L)$$

Recall that in order for the expected value (expected result) of our trading to be positive, the winning amount (A_W) must be at least the same size as the losing amount (A_L). That is to say, we'll need a minimum risk-reward ratio of 1:1.

Keep in mind that this formula presumes that **price trends are more likely to continue than reverse.**

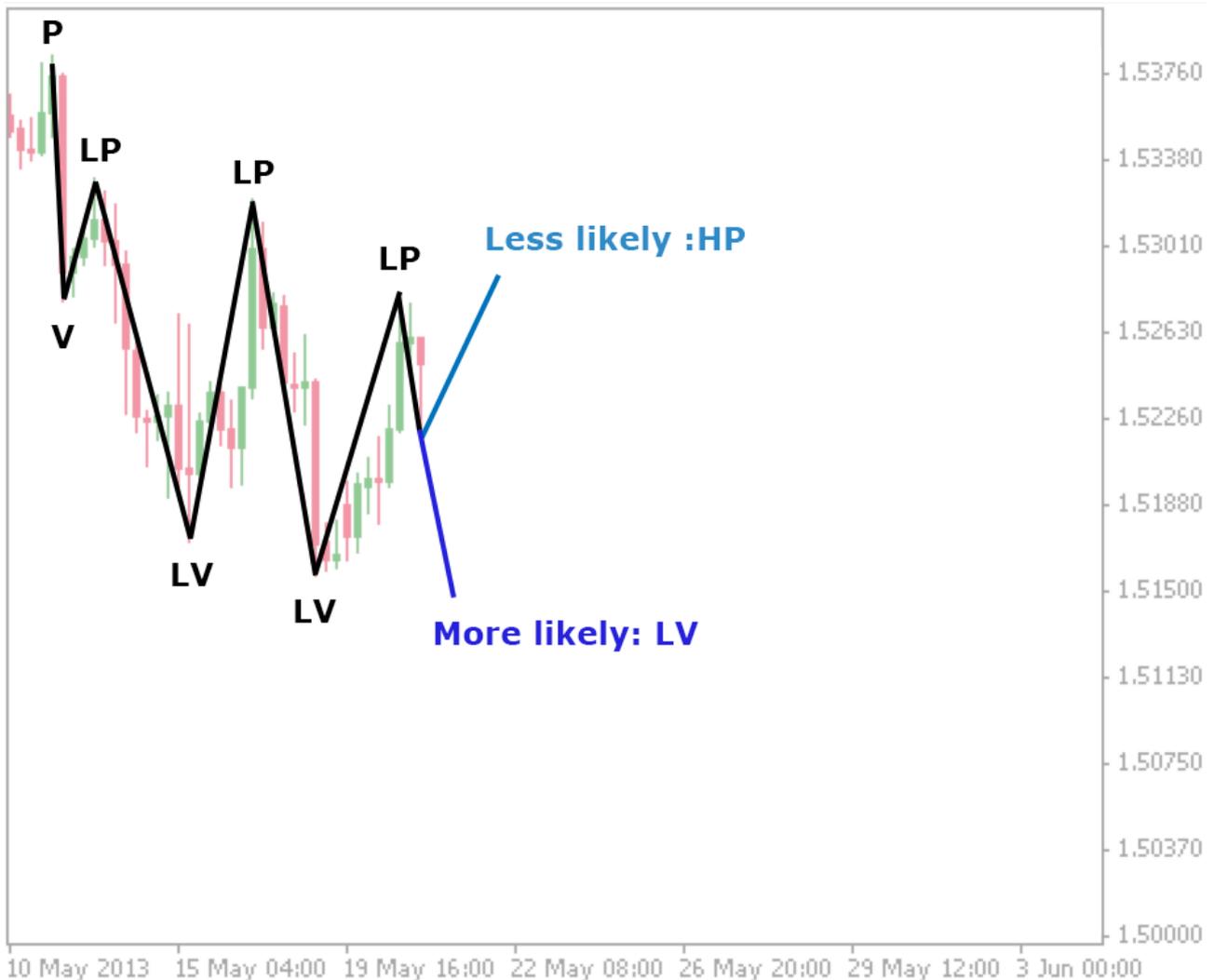


Uptrend





Downtrend



In summary,

1. We'll definitely be closing the trade when prices move below the latest valley in an uptrend (or above the latest peak in a downtrend)
2. We assume that prices are more likely to make a higher peak in an uptrend (or a lower valley in a downtrend)
3. We should only enter trades with at least a 1:1 risk-reward ratio

Point 1 tells us where to set a stop loss, while Point 2 tells us where to set a profit target.



Now that we have determined where to set the stop loss and profit target, there is only one place to set our trade entry order so that we have a 1:1 risk-reward ratio: at the halfway point of the latest impulse wave.

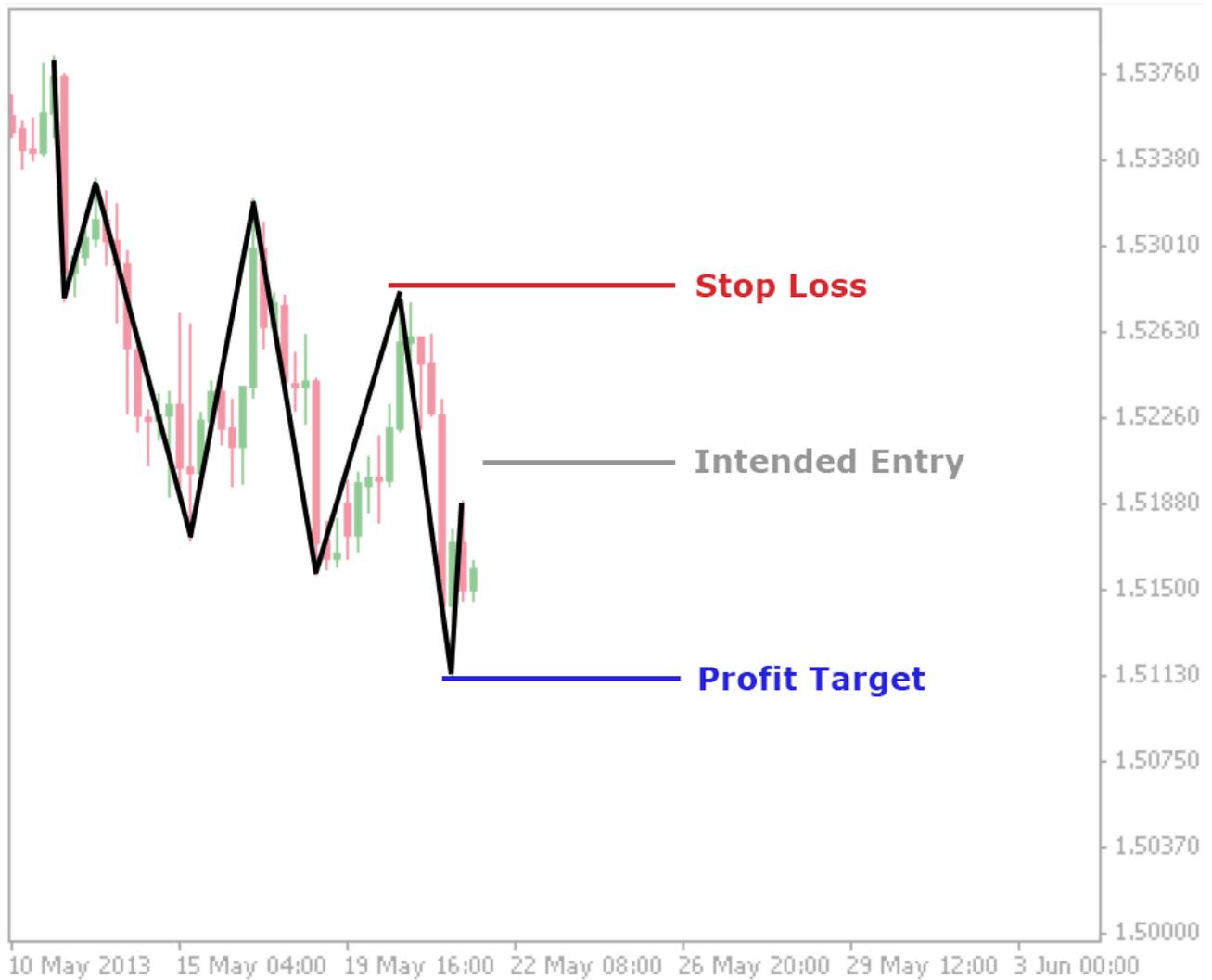


Uptrend





Downtrend



Does this make sense?

If it doesn't, re-read this section again until you understand the reasons for setting the stop loss, entry and profit target levels in this manner.

It's important that you understand the thinking process behind these decisions.



Now of course, we can also set our trade entry with a better risk-reward ratio, like this:



But don't forget: the larger the pullback wave, the weaker the trend is.

There is thus a conflict here, because as much as possible, we want to take trades with a risk-reward ratio better than 1:1... but if we get it, it also means that the trend is weaker than we'd like it to be.

In a later chapter, we'll look at how to deal with this conflict by extending our profit target. For now though, we'll settle for taking trades at the 50% pullback level of the latest impulse wave.



Trading Time Frame

In theory (i.e. in the absence of real-life constraints), we can trend trade on all available time frame charts.

In practice however, it will not make sense to do so on time frames lower than 4 hours.

Why? Because when we trade on the smaller time frames, the *proportion* of profits that go to the broker (in spread fees) will be relatively large, which works against our chances of survival in the market.

In a nutshell, here's what I mean:

	Profit	Spread Fee	Fee Percentage
Short Term Trade	20 pips	2 pips	10%
Medium Term Trade	100 pips	2 pips	2%

In taking short term trades, we'd have to pay our brokers a significantly larger portion of our hard earned profits than if we traded on the longer timeframes.

Of course, the brokers know this. This is why they tend to promote short term trading. It's good business for them.

Now consider that every extra dollar we pay the broker (in spread fees) is another dollar lost from our bottom line.

In an environment specially set up for retail traders to lose, every extra dollar we save is another one that keeps us alive and thriving. With this in mind, we will focus on trading the **4 hour** and **daily time frames**.



Trend Appraisal

In a previous chapter (*Basic Trend Framework*), we examined the overall structure and basic components of a price trend.

Now in this chapter, we'll zoom in on the less obvious details that will determine whether we should be participating in the trend we're looking at.

Not every trend is worth trading, and if we want to succeed over the long run we have to learn to identify the types of trends to avoid.

Think of Trend Appraisal as a filtering process upon which the poor quality trends are 'weeded out', so we can focus our time and attention on the trends that are more likely to provide us with winning trades.

When it comes to judging the quality of a price trend, there are essentially 3 dimensions to it:

1. Wave Regularity
2. Trend Potential
3. Economic Fundamentals



1. Wave Regularity

This dimension is about the *consistency* of the length of the impulse waves.

In a high quality price trend, the length the impulse waves tend to be similar:





In a poor quality trend, the length of each impulse wave tends to be significantly different than the others:



As much as possible, we want to only trade the markets that have consistent, regular impulse waves and avoid trading the markets with erratic impulse waves.



2. Trend Potential

Trend Potential, as the name suggests, is about estimating the likelihood for prices to *keep* trending in the near future.

As a rule of thumb, the longer a trend has been running in the absence of fundamental drivers (i.e. fundamental reasons), the less likely it will continue.

For example, if there is no significant change in the economic fundamentals in the Eurozone or United States, we would not expect a significant price trend on the EUR/USD.

The implication of this is that we'll need to have a basic understanding of economic fundamentals, and I recommend that all traders spend time studying it. In the next section, we'll talk more about this topic.

The next thing to look out for is a technical over-extension of the trend.

This happens when we see a *divergence* on the **Relative Strength Index (period: 14) indicator**.

*Note: It doesn't really matter which method (or indicator) you use to estimate the technical over-extension of a price trend, as long as you understand how it works and it does not contradict the trend trading philosophy.



In the chart above, we see that this market was initially in an uptrend, with a series of higher peaks and higher valleys.

Towards the middle of the chart however, we see that although prices continued to make *higher* peaks, the RSI line was instead making *lower* peaks. This is what we call an **RSI divergence**.

The idea here is that in an uptrend, the RSI line should form higher peaks as the market price forms higher peaks.



Similarly, in a downtrend the RSI line should form lower valleys as the price forms lower valleys.



In the chart above we see that prices were initially in a downtrend, and in the middle of the chart we see prices forming a lower valley (as it should).

However, notice that the RSI line formed a *higher* valley instead. This is a sign of a potential reversal, and we should not be looking to take a trade here.

RSI divergences do not guarantee a price reversal (nothing can), but they are reliable enough for us to add to our trading toolbox, especially when applied in combination with the other concepts covered in this book.



The last way to gauge the potential of a price trend is with simple support/resistance lines.

In accordance with basic technical analysis, we can draw **horizontal support/resistance lines** on the chart to mark out the major price level(s) where the market price had previously been unable to penetrate.

If the market price begins to approach these support/resistance areas, we will refrain from entering a new trade, or consider closing our in-the-money trades.



In the chart above we see an initial strong impulse wave followed by a Type A pullback wave. And now recently, prices are in a weak uptrend.



In this situation, there is clearly a major resistance level near the 1.6810 level. Thus, although prices are technically in an uptrend we will not be trading this market due to a significantly lower chance for the trend to continue.

Remember: The default expected value of retail trading is negative. This means that while a few retail traders may succeed in this environment, most will not.

The looser we are about our trading criteria (i.e. more often we take trades), the more likely we'll find ourselves in the latter group.

This is why we must act conservatively and take trades *only* when odds are clearly in our favour.



3. Economic Fundamentals

As trend traders, it will be very helpful for us to understand the basics of economic fundamentals, since they are often the main driver of large price trends.

The first thing to note is that medium-to-long currency prices are strongly influenced by **expectations of future interest rates**.

The higher the expected future interest rate of a country (relative to that of another country), the more its currency strengthens.

For example, if people are expecting interest rates to rise over the coming months in the United States, while the interest rates in the Eurozone are expected to remain unchanged (or lowered), we can expect the EUR/USD to keep trending down as the U.S. Dollar strengthens relative to the Euro.

In this sense, a basic understanding of interest rate policy (monetary policy) is crucial for us because it often determines the **direction** and **magnitude** of currency price trends. The more interest rates are expected to change, the further currency prices will trend.

This begs the question... how do we know whether interest rates are expected to rise, fall, or remain unchanged?

The answer lies in economic indicators.



Quick Definition

Economic indicators are official studies and surveys that measure how an economy is doing. They measure national production statistics, sales numbers, consumer sentiment, employment levels and inflation, among other aspects of an economy.

The more positive these numbers, the faster an economy is expected to grow, and the more the Central Bank will be expected to raise interest rates to cool down the economy.

Economic indicators tell us how well an economy is doing, which helps us avoid taking trades in the wrong direction.

For example, if the economic indicators show a weak Eurozone economy, we can expect the European Central Bank to keep interest rates low. Thus, it might be a good idea to participate in a downtrend (if any) on the EUR/USD.

You can follow the schedule (and results) of economic news releases at the Forex Factory website (forexfactory.com).

I would also encourage you to record the historical data of important (high-impact) economic indicators so you can keep track of each nation's economic trends.

This is a topic we cover comprehensively in the Icarus Project. If you'd like to find out more you can check it out at: www.pipmavensicarus.com



Wave Pairs

A price trend can be viewed in terms of a series of impulse-pullback wave pairs:



By observing the dynamics of each wave pair, we can get a more accurate understanding of the overall price trend they are part of.

For each wave pair, we consider the pullback wave to be a **reaction** to the impulse wave just before it.

Think of each impulse wave as the market saying, "I want to go this way", and the pullback wave is the reply.



With this perspective, the size of the pullback wave (of each wave pair) will tell us a lot about the likelihood of the continuation of the trend.

In particular, the larger the pullback wave and the longer it takes to form, the stronger its opposition to the impulse wave, and the less likely prices will keep trending.

As discussed earlier, there are 3 types of pullback waves:

1. Type A pullback
2. Type B pullback
3. Type C pullback

Among these pullback types, Type A is the one we will ignore for now, since — as established earlier — we should only enter a trade when prices make a pullback to the 50% level of the impulse wave (to maintain a 1:1 risk-reward ratio).

Thus, we will be trading only on wave pairs with either a Type B or Type C pullback.

Wave Speed

In everyday life, speed is a measure of distance traveled over time.

Speed increases when:

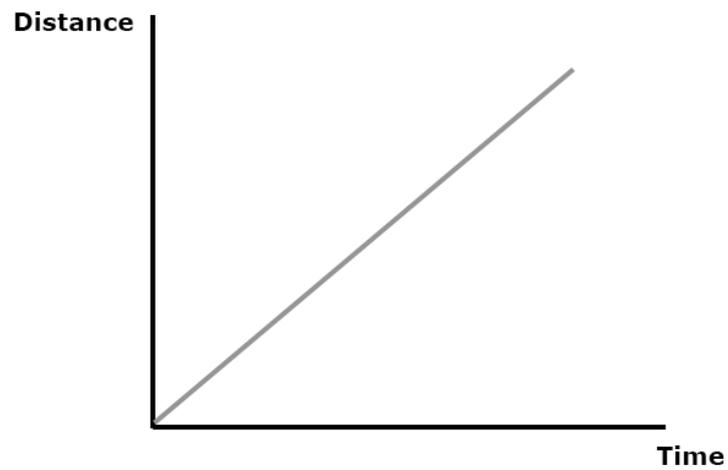
- The same distance is traveled over a shorter period of time; or
- A longer distance is traveled over the same period of time



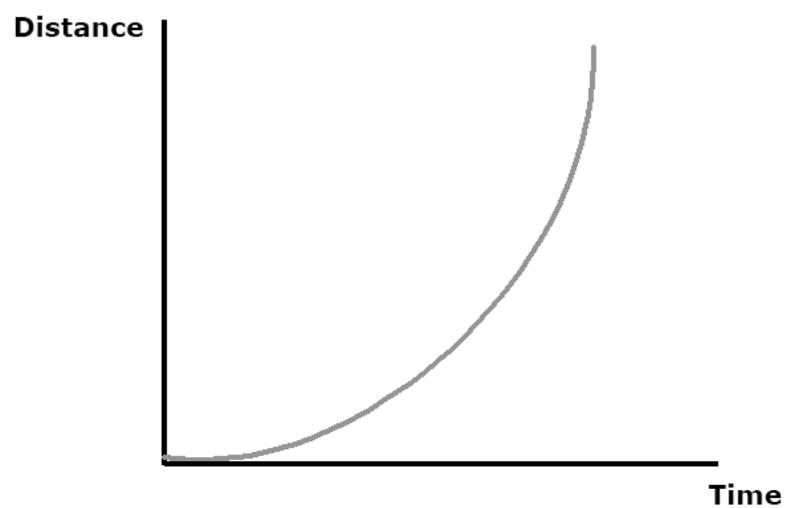
Speed decreases when:

- The same distance is traveled over a longer period of time; or
- A shorter distance is traveled over the same period of time

When we chart the *constant* speed of an object, we get a graph like this:

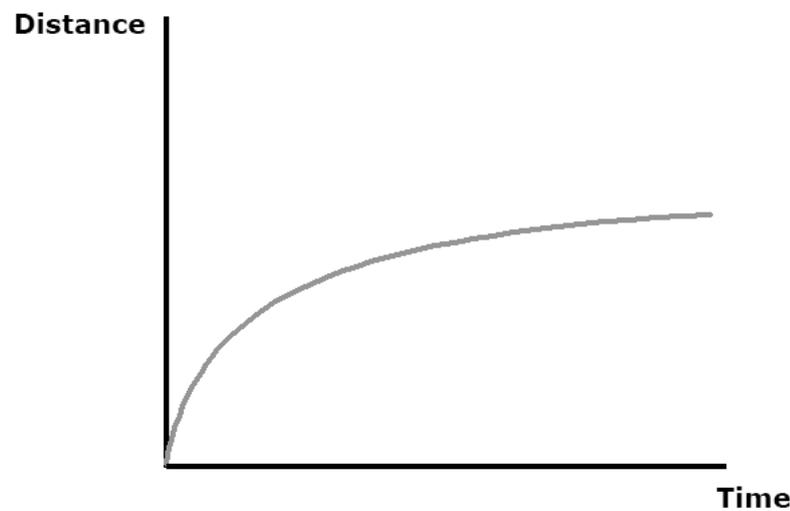


When we chart the *increasing* speed of an object, we get:





When we chart the *decreasing* speed of an object, we get:



A helpful way to think about this is that **the steeper the slope, the higher the speed.**

As the line gets steeper over time, it means that speed is increasing, and conversely, if the line gets less steep over time it means that speed is decreasing.

In a similar manner, we can observe the “speed”, or “strength” of the price waves. The only difference here is that instead of measuring speed in terms of ‘distance traveled over time’, we’ll measure it in terms of ‘pip movement over time’.

With this concept, we can assess the overall strength of a price trend by observing the speed of the individual waves.



We'll do this by:

1. Comparing the speed of each impulse wave to the speed of the pullback wave (of each wave pair)
2. Observing any increase (or decrease) of speed among the impulse waves
3. Observing any increase (or decrease) of speed among the pullback waves

Example:



Take a look at the chart above. What does the speed of the waves tell us about the overall trend?



First wave pair (bottom left)

- Impulse wave started strong, but slowed down before the pullback wave
- Pullback wave was relatively weak (Type A)

Second wave pair

- Impulse wave was not as strong as the previous impulse wave. There was a slight bounce (weakness) in the middle of this impulse wave
- Pullback was stronger (Type B) compared to the previous wave pair.

Third wave pair (top right)

- Impulse wave was strong
- Pullback wave has not yet formed



Based on these observations, we can tell that this trend started strong (with the first wave pair), but then started to weaken (with the second wave pair).

However, the latest (third) impulse wave has regained some of that strength so we can say that on the whole the trend is still looking “healthy” and that we may consider trading it.

Another example:



What are the wave pairs telling us about this trend?



Let's see...



First wave pair

- Impulse wave was very strong
- Pullback wave was weak (Type A)

Second wave pair

- Impulse wave was significantly weaker (shorter) than the previous impulse wave
- Pullback wave was strong (Type C), and was larger than the previous pullback wave



This tells us that although the price trend started strong, it has now weakened considerably. In this case, unless there are strong fundamental reasons to join the trend, we would probably want to stay out of this market.

Big V Warning Sign

There is a special type of wave pair that often signals the end of a trend.

It does not necessarily predict a trend change, but it's reliable enough to serve as a warning signal for us to stay out of the market.

I call it the Big V because that's exactly what it looks like on the trading chart.





The Big V is formed when the market price makes a rapid move in the direction of the prevailing trend. This attracts the participation of other traders as they attempt to join in on the move.

Soon after though, the demand dries up and the price slingshots back in the opposite direction. Instead of making a slow, measured pullback, the market price quickly races back to its prior level, forming a symmetrical V shape.

The defining characteristic of the Big V is the **narrow** and **steep** V-shape pattern.



Example:



FOREXWINNERS.RU



Example:



The problem with the Big V is that most of the time it is identifiable only on hindsight. This is a problem for us because our usual trade entry is located at the 50% pullback level, which would be triggered before the Big V is fully formed.

So how can we avoid falling prey to a Big V reversal while looking to take our trades?



The trick is to pay attention to how aggressive the pullback wave is. If we see the pullback wave moving quickly, we'll simply stand aside and *not* set a trade entry order.

We will only set a trade entry order (at the 50% level) *after* we see the pullback wave moving in a slower, more measured pace.

For example:



In the chart above, we are not sure if a Big V will be formed here. However, looking at how aggressive the pullback wave is, that might just happen... so it would *not* be a good idea to set a pending sell order at this point.



Another example:



In the chart above, we see that the latest pullback wave did not rally aggressively following the impulse wave, and instead consolidated near the bottom. This is not what the Big V pattern looks like so it is now safe to set a pending sell order at the 50% pullback level as per normal.

The takeaway is that when we see an aggressive impulse wave followed by an equally aggressive pullback move, we should be on high alert and hold back from setting a trade entry order.

We will only look to set an entry order when the pullback move looks weaker than the impulse wave.



Wave Fractals

A single wave on the larger time frame chart is often comprised of a series of smaller waves on a smaller time frame chart.

For example, each wave on the daily chart may consist of a series of smaller wave on the 4 hour chart:



This will be very helpful for us, since whenever we are doubtful or confused about any wave (or wave pair), we can simply zoom in and inspect the smaller time frame waves to get a more detailed look at the situation.



Summary

This chapter is all about judging the quality of an ongoing price trend, to determine whether we should be trading in that market.

In particular, we'd have to consider the characteristics of the wave pairs and the potential for the trend to continue.

This is important because one of the fastest paths to failure as trend traders is to blindly trade every trend we see. The market constantly tempts us with poor trading opportunities (bad apples) and it is our job to filter them out and to only spend our time on the good quality ones.

Ultimately, our trend appraisal skill will determine the level of our trading success. As such, I would suggest that you regularly come back to revise this chapter.



Trade Entry Procedure

So far, we've examined trend trading concepts largely from a conceptual point of view. We discussed the *what* and the *why*, and it is now appropriate to take a look at *how* these concepts are applied in practice.

1. First, we'll open up the trading chart to the daily (or 4 hour) time frame. This is where we'll look for a price trend by observing the moving average line and consecutively lower (or higher) peaks and valleys.





2. Next, we'll pay attention to the various characteristics of the trend (that we covered in the Trend Appraisal chapter) to decide if this is a trend we want to be trading.
 - How long has the trend been going on?
 - Are there any fundamental reasons supporting/driving it?
 - How consistent are the price waves? Are the impulse waves slowing down? Are the pullback waves predominantly Type A, B or C? Etc...
 - Does this trend have the potential to keep going? Are there any major support/resistance levels coming up? Is there an RSI divergence?
3. Once we've assessed the quality of the trend, we will decide to either trade it, or to look for opportunities elsewhere. If we decide to participate in the trend, we will wait for a pullback wave.
 - If the pullback looks aggressive (as in the case of a Big V), we will stay out of the market and monitor the situation. Once a Big V is confirmed, we will walk away not take the trade
4. If the pullback wave isn't too aggressive, a pending order will be set at the halfway point of the latest impulse wave. A stop loss order will be set 1 pip behind the impulse wave, and the profit target will be set at the other end of the impulse wave (in the direction of the trend).



5. If the trade is not triggered and prices continue to trend, we will delete the pending order and wait for another pullback from the next impulse wave
 - If the pending order is triggered, we'll move on to the trade management phase.



Trade Management

Once a trade is triggered, we'll watch for signs of trend weakness and be ready to manually close the trade, if the situation calls for it.

50% Pullback Reaction

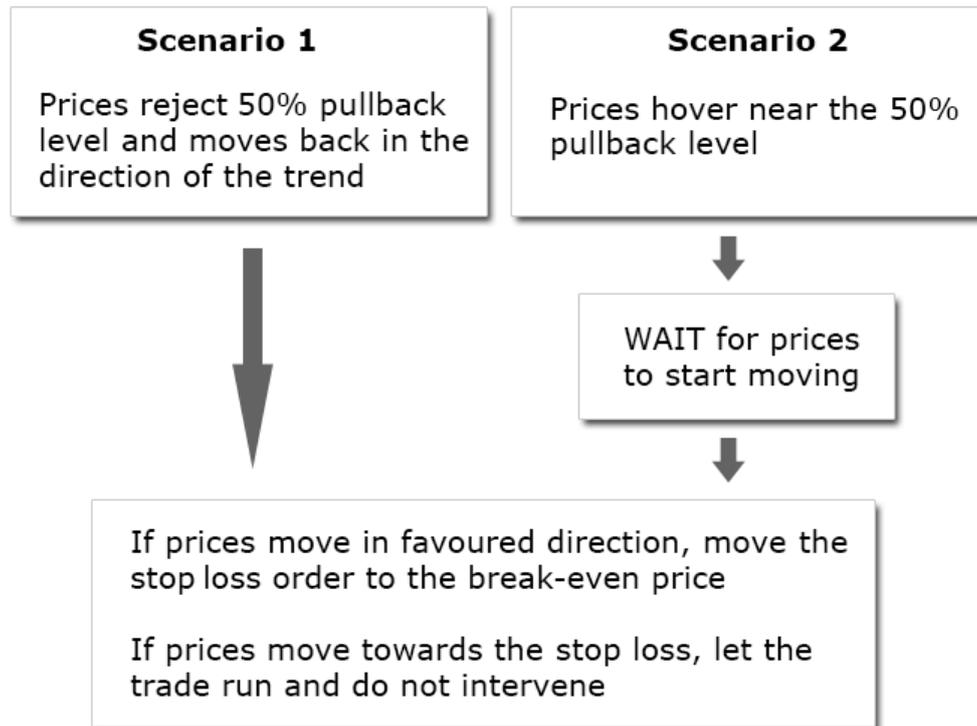
There are basically 3 scenarios that can happen after the market price hits the 50% pullback level (thus triggering our trade entry):

1. Prices reject that level and quickly move back in the direction of the trend
2. Prices hover near the 50% pullback level
3. Prices move past the 50% pullback level and keeps moving closer to the stop loss level

Under the first two scenarios, we will observe the price action and be ready to move the stop loss order to the break-even price when prices move in our favoured direction with significant momentum.

In these two scenarios, the market is telling us that the pullback wave is relatively weak (compared to the impulse wave), so we can be patient and wait for the trend to resume.



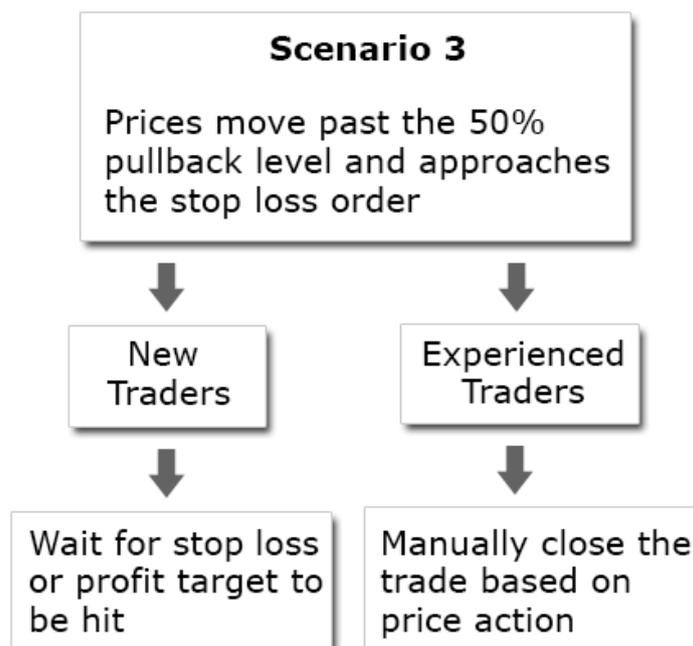




Under the third scenario, things are a little trickier. What should we do when prices moves past our trade entry and approaches the stop loss order?

A simple approach would be to keep the trade open until prices either move back in the direction of the trend, or until the stop loss order is triggered. This is the option I'd recommend for new traders.

Alternatively, we may choose to manually close the trade for a loss if we think the stop loss will probably be triggered. This approach requires a certain level of price action competency and should only be reserved for more experienced traders.







Money Management

Money management is all about choosing the appropriate lot size to trade with. This matters because the size of our profits and losses are directly related to it.

You see...

When we trade with a large lot size, our profits and losses are large.

When we trade with a small lot size, our profits and losses are small.

So although we would like our profits to be large and our losses to be small, the reality is that we can't have it both ways. We must either choose to be aggressive or defensive with our trading lot size.

And if we think about it, there is actually only one rational choice. Allow me to explain...

Let's say we take a series of 10 trades, each with a lot size that risks 4% of our trading capital. Now imagine that we win the first 5 trades, and lose the last 5 trades. Here are the results we'd get:

Trade	Capital	% Risk	Profit	Loss	Result
1	\$10,000	4%	\$400	-	\$10,400
2	\$10,400	4%	\$416	-	\$10,816
3	\$10,816	4%	\$433	-	\$11,249
4	\$11,249	4%	\$450	-	\$11,699
5	\$11,699	4%	\$468	-	\$12,167
6	\$12,167	4%	-	-\$487	\$11,680
7	\$11,680	4%	-	-\$467	\$11,213
8	\$11,213	4%	-	-\$449	\$10,764
9	\$10,764	4%	-	-\$431	\$10,334
10	\$10,334	4%	-	-\$413	\$9,920



Notice that even though there's an equal number of winning and losing trades, we'd end up with less capital than we started with.

And in case you're wondering, the *sequence* of the winning/losing trades doesn't matter. Here are the results if we had 5 losing trades followed by 5 winning trades:

Trade	Capital	% Risk	Profit	Loss	Result
1	\$10,000	4%	-	-\$400	\$9,600
2	\$9,600	4%	-	-\$384	\$9,216
3	\$9,216	4%	-	-\$369	\$8,847
4	\$8,847	4%	-	-\$354	\$8,493
5	\$8,493	4%	-	-\$340	\$8,154
6	\$8,154	4%	\$326	-	\$8,480
7	\$8,480	4%	\$339	-	\$8,819
8	\$8,819	4%	\$353	-	\$9,172
9	\$9,172	4%	\$367	-	\$9,539
10	\$9,539	4%	\$382	-	\$9,920

And here are the results if we had alternate winning and losing trades:

Trade	Capital	% Risk	Profit	Loss	Result
1	\$10,000	4%	\$400	-	\$10,400
2	\$10,400	4%	-	-\$416	\$9,984
3	\$9,984	4%	\$399	-	\$10,383
4	\$10,383	4%	-	\$415	\$9,968
5	\$9,968	4%	\$399	-	\$10,367
6	\$10,367	4%	-	-\$415	\$9,952
7	\$9,952	4%	\$398	-	\$10,350
8	\$10,350	4%	-	-\$414	\$9,936
9	\$9,936	4%	\$397	-	\$10,334
10	\$10,334	4%	-	-\$413	\$9,920



As you can see, the final result is the same — we end up with less capital that we started with.

This is how the law of percentages works against traders. Even with an *equal* number of winning and losing trades, we'd still walk away with a net loss.

Now consider that as we lose more capital, it gets *increasingly* harder to make it back:

Starting Capital	Loss	Result	\$ needed to break even	% needed to break even
\$10,000	-1%	\$9,900	\$100	1.01%
\$10,000	-5%	\$9,500	\$500	5.26%
\$10,000	-10%	\$9,000	\$1,000	11.11%
\$10,000	-25%	\$7,500	\$2,500	33.33%
\$10,000	-50%	\$5,000	\$5,000	100.00%
\$10,000	-75%	\$2,500	\$7,500	300.00%
\$10,000	-90%	\$1,000	\$9,000	900.00%

If we lost 1% of our capital, we would have to make a 1.01% profit to get back to break even. If we lost 25% of our capital, it would take a 33.33% profit to do the same.

Now what if we lost 50% of our capital? We would then have to make a 100% profit just to break even.

These examples highlight another negative bias that traders face. As we lose capital, it doesn't just get more difficult for us to break even... it gets *exponentially* more difficult.



In an earlier chapter we talked about the negative profit expectation suffered by retail traders. In this chapter, we're talked about the mathematical (percentage) bias of losses vs gains.

Both phenomena work against us, and the only rational way to deal with them is to trade less often, and with small lots.

Ironically, this is the opposite of what most retail traders do, which is to trade too often and with too large a lot size. Unsurprisingly, most of them end up losing money, after which they'd blame everyone else but their ignorance.

The simple truth is that they are not aware of the fact that the retail trading environment is *structured* to work against them in the first place. And not only that, the laws of mathematics punish losing traders more than it rewards winning ones.

The implication of this is that we have little choice but to trade conservatively rather than aggressively. For us, defence is more important than offence.

Now we are ready to address the question: what's the appropriate percentage of capital to risk per trade?

For our purposes, it would be reasonable to **risk 1 - 2% of our capital per trade**, or less.

In practical terms, this means that if we have a \$10,000 account, we may risk \$100 - \$200 per trade. If we have a \$2,000 account, we may risk \$20 - \$40 per trade, and so on.



Let's say (for example) that we've decided to risk 2% per trade on a \$10,000 account. That's \$200 per trade.

We've also just identified a suitable price trend and are just about to set a pending trade order:



In order to determine the lot size for this trade, we'll need to know the stop loss allowance in terms of pips. In this case, the stop loss is **79 pips** away from the intended entry price.

So for this trade, we'll be risking \$200 across 79 pips, which means that we'll risk \$2.53 ($\$200/79$) for each pip of market price movement.



Now the question left to ask is: what trading lot size will enable us to risk \$2.50 per pip?

Here's a table that summarises the relationship between lot size and value-per-pip:

Lot Type	Amount of Currency	Value per Pip
Standard	100,000	\$10.00
Mini	10,000	\$1.00
Micro	1,000	\$0.10
Nano	100	\$0.01

Since trading with 1 mini lot enables us to risk \$1 per pip, we'd have to trade with 2.5 mini lots (i.e. 25,000 units of currency) in order to risk \$2.50 per pip. That's the appropriate lot size to use for this trade.

Note that since the stop loss allowance for each trade will be different (depending on the size of the impulse wave), the trading lot size will be different as well.

By dividing the risk capital (in this case \$200) across the stop loss allowance, we will risk only the intended amount (again, \$200) regardless of the size of the stop loss allowance.

This ensures that in each of our trades, we'll risk exactly the same percentage of capital even though the stop loss allowances are different.



Trend Trading Philosophy Revisited

Let us now go back to the bigger picture and revisit the *reasons* for trend trading.

So far, we've established that retail traders face a

1. Negative profit expectation (retail traders are net losers); and a
2. Negative percentage bias (% losses have a bigger impact on our account than % gains)

This means that if our winning percentage is 50% (or lower) and our risk-reward ratio is 1:1 (or poorer), we are almost certain to lose in the long run.

Thus, the only effective way to consistently make money in such an environment is to:

1. Have more winning trades than losing ones; and/or
2. Profit more per winning trade than is lost per losing trade (i.e. trade with a risk-reward ratio better than 1:1)

Trend trading is the most effective approach to satisfy both criteria, but we have so far only discussed the first one in detail.

Now, we are ready to fulfil the second criteria by extending our profit target.



Profit Extension

Since our stop loss and entry orders will not be moved, the only way we can improve our risk-reward ratio is by extending our profit target.

However, in doing this we run the risk of prices reversing just after hitting our original profit target, without hitting the extended target.

Thus, we will cover our bases and close half the trade when the original profit target is hit, and allow the remaining half of the trade to continue running.

This way, if prices reverse after hitting the original profit target, we'll at least have secured a portion of the profit.

There are 3 ways we can extend the profit target:

1. At a predetermined level (based on Wave Projection)
2. With trailing stop loss
3. Upon an RSI divergence

1. Wave Projection

Wave Projection is based on the hypothesis that the market moves symmetrically.

For our purposes, this simply means that the length of the latest uncompleted impulse wave is likely to be similar to the length of the *previous* impulse waves.



We can thus set an approximate profit target based on the length (in pips) of the previous impulse waves:



In this example, we see the the average length of the previous impulse waves is 223 pips. To be slightly conservative, we may set the extended profit target 200 pips away from the latest valley.



2. Trailing Stop Loss

Instead of setting a fixed profit target, we may simply set a trailing stop loss either beyond the previous day's high (or low) or beyond the latest peak (or valley).

This is a hands-off approach and is the recommended one for traders who don't wish to spend time monitoring their trades regularly.

The downside of this method is that traders will often give up a significant portion of their profits before the stop loss is hit and the trade is closed.

3. RSI Divergence

An RSI divergence suggests an over-extension of the trend, and we may decide to close a profitable trade when we see a clear divergence between market prices and the RSI line.

Note that trends do not always end with a RSI divergence, so this is just something to watch out for, rather than to be expected.

In practice, I use a combination of all 3 approaches to decide where to close the remainder of my profitable trades.



Trade Journal

Back when I first started trading, I didn't keep a trade journal. I just wanted to make money and figured that a journal would just get in the way of that.

Looking back now, it's clear that I had it exactly the wrong way around. In fact, it was my insistence on *not* using a journal that obstructed my progress.

For a long time, I was losing money in the market without understanding why. It was only later when I started keeping a trade journal that I realised I was repeating the same mistakes without being aware of it.

Now let me ask you:

Do you think you're repeating the same trading mistakes?

Before you answer, bear in mind that most people would say no. When uncertain, people tend to give an answer that is most comfortable for them.

So... do you think you're repeating the same trading mistakes?

...

..

.

Now here's the kicker...

Regardless of your answer... *how do you know whether it's true?*

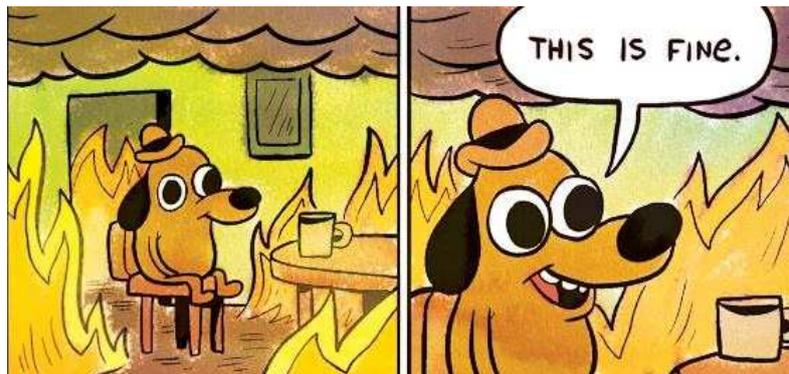


Subjectivity Obstructs Progress

If you think you are repeating the same mistakes, how do you know that is in fact the case? Likewise... if you don't think you are repeating mistakes, how do you know?

You see, we tend to answer questions like these anecdotally (i.e. based on memory).

Unfortunately, human memory is a highly unreliable source for objective information. People tend to see what they want to see and believe what they want to believe.



by KC Green

Whether we like it or not, the most reliable way to remember our trading decisions is to write them down. This way, those decisions won't be coloured by our mental and emotional biases when we try to remember them later.

This, in essence, is the function of a trading journal. It helps us to clearly observe our trading performance without the cloud of emotional subjectivity.



If I may draw an analogy, keeping an updated journal is like driving a car with clear front and rear windshields. We can easily tell where we've been, and where we're headed.

Conversely, trading without a keeping journal is like driving a car with blocked windshields. We might *think* we know where we're going, but the reality is likely to be very different from what we have in mind.

For us, updating and reviewing the trade journal are two of the most important things we can do to improve our trading.

What To Write Down

The ultimate purpose of a trade journal is to provide an objective way for us to check on ourselves by answering the question: **did I follow my trade plan?**

We will thus be recording, *before* we enter a trade order:

- A screenshot of the price chart on the 1 hour, 4 hour and daily time frames
- The entry, stop loss and profit target levels
- Any fundamental reasons for taking the trade

After the trade is closed, we will:

- Take a screenshot of the price chart on the 1 hour, 4 hour and daily time frames
- Mark out on these charts where the trade was entered and closed
- Answer the question: did I follow my trade plan?

That's it.



With this, we'd have a number of trades to review at the end of every month.

Upon reviewing each trade, we'll ask ourselves:

- Why did I lose on this trade? What did I do wrong? Did I miss or forget anything? Is this an acceptable mistake? Was it preventable?; or
- Why did I win on this trade? What did I do right?

If you can do this on a regular basis, you'll be way ahead of most retail traders simply because you'll be improving based on an objective measure while they continue to rely on subjective memory.

Once again, I cannot over-emphasise how important it is to keep a regularly-updated trade journal. If I had to pick one thing that helped me improve my trading the most, this would undoubtedly be it.

Unfortunately, keeping a journal is often regarded as the most boring aspect of trading, which is why most people neglect it.

The good news is that once you start uncovering the mistakes you're repeating (via your journal), the process will quickly become enjoyable and perhaps even a little addictive.



In this chart we see prices moving in an uptrend with — as it seems — a new impulse move just underway.

At this point, a number of trend traders would be holding on to a long position with a stop loss order placed below one of the recent valleys.

However, look what happens next...



The market price breaks to the downside, triggering the stop loss orders of the traders who were long this market.



According to our definition of a trend, we would now consider the uptrend to be over, since the prices have now formed a lower valley.

But look what happens next:



After shaking those traders off the trend, the market price quickly resumes the uptrend move!

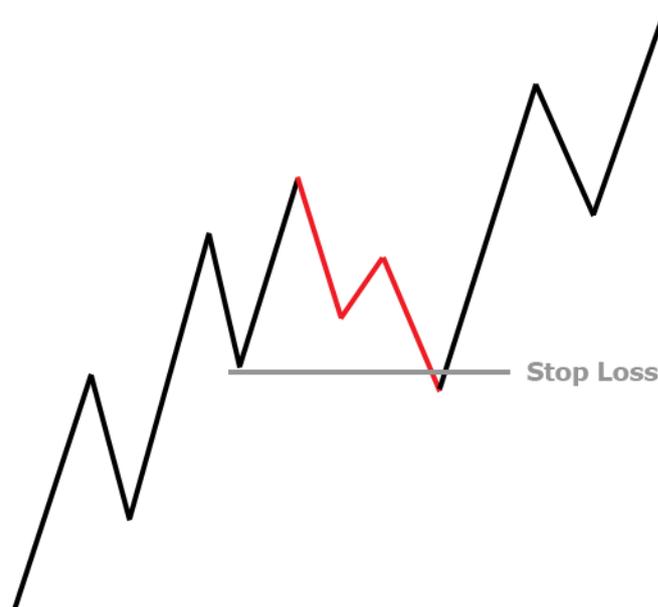
This is what I mean when I say that a complex pullback gives the *appearance* of the end of a trend.



In an uptrend, we expect to see consecutively higher peaks and valleys, but a complex pullback (below, in red) breaks this rule.



The trouble with complex pullbacks is that they often move beyond the prior valleys in an uptrend (or beyond prior peaks in a downtrend), triggering traders' stop loss orders that are placed there:





Complex pullbacks pose a challenge for trend traders because there is no clear-cut way to deal with them.

There are however, a couple of precautions we can take to reduce or even negate the negative impact of complex pullbacks, when they occur.

1. Trade smaller lots in a trend with 2-3 (or more) impulse waves

Complex pullbacks tend to occur after a trend has been running for some time. They rarely occur at the beginning of a trend.

Thus, when entering a trend with 2-3 (or more) impulse waves, we may choose to do so with a smaller-than-usual lot size, to reduce the loss in the event of a complex pullback.

2. Enter the trade at the 50% pullback level of past 2-3 impulse waves

Normally, we would set a pending entry order at the 50% pullback level of the latest impulse wave.

However, if we see that the latest few impulse waves are relatively small (i.e. short), we may instead set a pending entry order at the 50% level of the past 2-3 impulse waves, like this:



This option should only be considered when there are strong fundamental reasons to believe that the trend will continue. Otherwise, we may very quickly find ourselves trading against the direction of a new (opposite) trend.

The ability to anticipate a complex pullback will ultimately be based on our assessment of the technical quality of the trend and the economic fundamentals of the countries involved.



Watch Out For Economic Indicator Releases

Price trends based on economic fundamentals rarely change in a single day.

More likely, it will take multiple economic indicator releases over a period of weeks (or months) before a major trend ends.

This said, there are some highly sensitive economic indicators that can change short-to-medium term trends when they are released.

A classic example is the Non-Farm Employment Report from the United States. This is the grand daddy of economic indicators, and a surprise number will often cause prices to fluctuate aggressively, triggering out all but the luckiest traders' stop loss orders!

To prevent such a situation from happening to us, we will **not set entry orders on currency pairs that have high-impact economic indicators being released on the same day.**

The release schedule can be found at the Forex Factory website: www.forexfactory.com/calendar. The ones we should avoid are the located next to the red icons (i.e. the high-impact releases).

I recommend that you check this site every day to remind yourself of the currencies to avoid trading for that day.



Wrapping Up

Although we've spent a significant portion of this book going through the technical details of trend trading, the real value of this book lies in the philosophy behind it.

Allow me to summarise the major points from a different perspective.

Every time we take a trade, we have to decide:

1. Whether to buy or sell
2. Where to set the stop loss
3. Where to set the profit target(s)
4. Where to enter the trade
5. The lot size to use

Now, given that we start out with the following disadvantages:

- A default negative profit expectation (i.e. the more often we enter the market, the more likely we'll lose in the long run)
- A negative mathematical/percentage bias (i.e. we can have the same number of winning and losing trades, and still lose money)

... what's a type of trading approach that answers the above 5 questions, and avoids the 2 weaknesses?

The answer, is trend trading.

Now let's go through the 5 questions in the context of trend trading.



1. Whether to buy or sell

Although there's no guaranteed way to predict future prices, we know that by definition, price trends are more likely to persist than otherwise.

It would thus be in our interest to enter trades in the direction of the prevailing trend.

2. Where to set the stop loss

Since we:

- Will only trade in a trend, and
- The trend is over when prices move beyond an impulse wave (in the opposite direction)

... then the logical thing to do is to set our stop loss just beyond the impulse wave.

3. Where to set the profit target(s)

Since:

- We expect a trend to continue, and
- A trend is maintained when prices make a higher peak (in an uptrend) or lower valley (in a downtrend)

... it would then make sense to set an initial profit target at the latest peak (in an uptrend) or latest valley (in a downtrend).



4. Where to enter the trade

Through the expected value formula, we established that the most reliable approach to profits in the long run is to use trade with a risk-reward ratio of at least 1:1.

Now, considering that the stop loss and initial profit target will be set at both ends of an impulse wave, this means that in order to maintain a 1:1 risk reward ratio, our trade entry point must be at the halfway point of the impulse wave.

5. The lot size to use

Given that it gets increasingly difficult to recover from growing losses, it is crucial that we never risk a significant portion of our trading capital on any one trade.

Thus, we'll risk a small 1 - 2% of the trading account (or less) on each trade.