

 Wiley Trading

THE NATURE OF TRENDS

STRATEGIES AND CONCEPTS FOR
SUCCESSFUL INVESTING AND TRADING



RAY BARROS

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WILEY

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*For Chrisy, with all my love.
From her have come all the good things in my life.*

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The second level of my gratitude belongs to my teachers, both direct and indirect. Peter Steidlmayer’s books and seminars put me on the road to successful trading. His influence permeates my trading, as does the work of Richard Wyckoff.

Joseph Hart also deserves special mention for his ideas on the Whole Point Count and Line Change Count.

Now to the third level: I wish also to thank all the students who enrolled in my course, *Successful Trading Concepts*. In the process of teaching them, I too became a student.

And finally, to the fourth: Robyn Flemming, my editor. Without her efforts, this would have been a much lesser work. Thanks, Robyn, for all your assistance!

Introduction

The trader today has assistance that the traders of old would have given their right arm for; certainly, *I* would have. They have unheard-of computing power, and the benefits of the gigantic leaps made in the study of neurology, decision making, psychology, and learning. Thanks to Neuro-Linguistic Programming, we now have the tools to model success.

But the sad fact remains that the ratio of financial successes to losses is not too different from when I placed my first order. Anecdotal evidence suggests that 80–90% of traders consistently lose money. Part of the problem is the computer. Computing power is both a blessing and a curse. It's a blessing in that statistical power is now available to all—thus providing the opportunity for better risk management. It's a curse because it has led traders away from the search for the principles that underlie market action, to a search for “angles” that are profitable but which have a “use-by” date. The black joke is that no one has told the newbie trader of the difference between the two. Nor has he or she been told why that difference is important.

What is an “Angle”?

Peter Steidlmayer called angles “behavioral parameters”—patterns that will make money as long as not too many traders use them. The market, being a complex, self-adapting system, renders angles ineffective (that is, they lead to a loss of your trading dollars) as soon as too many traders use them.

In the early days of *Market Profile*, there was a behavioral parameter called the “Value Area” rule. This rule stated that if on a rotational day—that is, a day that moved from high to low, low to high, as distinct from a directional day—the market accepted prices below the “Value Area,” there was an 80% probability that the market would go to the opposite boundary.

Well, for a while it was money for jam. But then the word spread and . . . I remember one day seeing this angle set up in the Australian 10-year bonds. The only problem was, this time, the next trade after the market accepted below the “Value Area” was at the opposite end! Yes, it was a particularly thin market, but from that day the hit-rate for this angle dropped for that instrument.

Another reason for the lack of success is the nature of the newbie trader. Until he learns that the market does bite, he believes that success is easy. After all, he can see the chart points for himself, can't he? It's so easy! *Here's the high, sell it; and there's the low, buy it!* And there's enough hype “out there” to reinforce this fantasy. Sure, he's heard the stories about the high failure rate, but that won't happen to *him*. It's strange that the newbie wouldn't dream of performing surgery without first undergoing years of medical training, while at the same time believing that all he needs to succeed in trading is money and courage.

Trading is a profession where the road to success is both difficult to follow and yet simple to pursue. It's hard because the application of the rules of success runs contrary to our nature; it's simple because the map to success has been clearly laid out.

Is there a solution? There is, and that is to think in terms of principles. My goal in *The Nature of Trends* is to explain the principles, or trading concepts, that have worked for me, and to relate those principles to the elements of a discretionary trading plan. Those elements are:

- Identify the trend, and where the market is located within the trend. Once you determine that, you have your strategy—that is, whether for this trade you are to be a buyer or a seller.
- With your strategy decided, you are ready to look for a low-risk entry. Five elements comprise low-risk entry:
 - *Zones*: for a responsive trader (a buyer on dips in uptrends; a seller on rallies in downtrends), zones are support (uptrend) or resistance (downtrend) areas that contain the correction.
 - *Setups*: chart patterns that provide confirmation that a zone is holding.
 - *Entry patterns*: chart patterns that confirm the zone has held and the trend resumed.
 - *Initial stop*: the cut-loss method based on time or price.
 - *Risk/reward*: the money management calculation that says there is value in the trade.
- Once you are in a trade, it's time to focus on trade management—how to exit profitably.

In short, *The Nature of Trends* considers the questions: *What is the trend?* And *Will it continue or change?*

I am inevitably asked: "If you're so successful as a trader, why do you . . . ?" My answer is a straightforward one. Each of us has four main desires:

1. *To live*: We all want a life that we envisage we would enjoy, including all the material trappings that life can bring. I have been lucky enough to experience that and more.
2. *To love*: We all want to have had the opportunity of loving and being loved; of being, for the person we love most in the world, the most important person in the world in return. Again, I have had that good fortune.
3. *To learn*: My parents taught me early that learning is a never-ending experience, and that it's up to each of us to be all we can be. I have never stopped wanting to learn.
4. *To leave a legacy*: This is one goal I haven't yet achieved, despite my best efforts. Perhaps this and future books will be my legacy. We'll see.

Outline of The Nature of Trends

Chapter 1 introduces my beliefs about trading success and about what is needed to reach your goals. It then describes a model of the market's structure, before concluding with a discussion of the Barros Swing and its relationship to the three trends—up, down, and sideways.

Chapter 2 discusses the change in trend patterns. Chapter 3 deals with the idea of "acceptance" and the function and impact of time frames. Chapter 4 looks at derivative indicators. Chapter 5 examines some of the important aspects of entry and trade management. Chapter 6 examines three instruments, and tracks a trade to illustrate the concepts explained in the book. Finally, the appendix explains how the Barros Swing is constructed, as well as Steidlmayer's method for calculating standard deviations—an approach quite different from statistical theory.

Chapters 1 to 5 begin with a pictorial road map that outlines the contents of the chapter.

One final, important point: **To facilitate your reading, some figures are duplicated so that you don't have to turn the page to find the chart to which the text is referring.** This is a novel approach. Please let me know if you have found it a useful innovation.

I welcome any queries on the construction of the Barros Swing. Send your enquiries to: ramonbarros@mail.com or visit www.tradingsuccess.com.

Definition and Identification of Trends

Welcome to *The Nature of Trends*. My desired outcome for this book is a simple one: that it be the vehicle that will enable you to achieve your financial goals. But I must admit that I do harbor doubts that this outcome will be achieved. The reason? Its attainment lies as much in your hands as it does mine.

So, let's make a deal: treat this book as a manual for your success. Don't just read it; study it, and integrate the ideas contained in it into your psyche through practice, and more practice. In return, I promise you that your trading will scale new heights. I know this, because many have gone before you and if the ideas set out here worked for them, why not for you?

INTRODUCTION

Modern learning theory says we learn best when we have a sense of where the text is leading us. The pictorial road map depicted in Figure 1.1 shows:

1. In this chapter, we will look first at my beliefs about the relationship between trading success and the nature of the market.

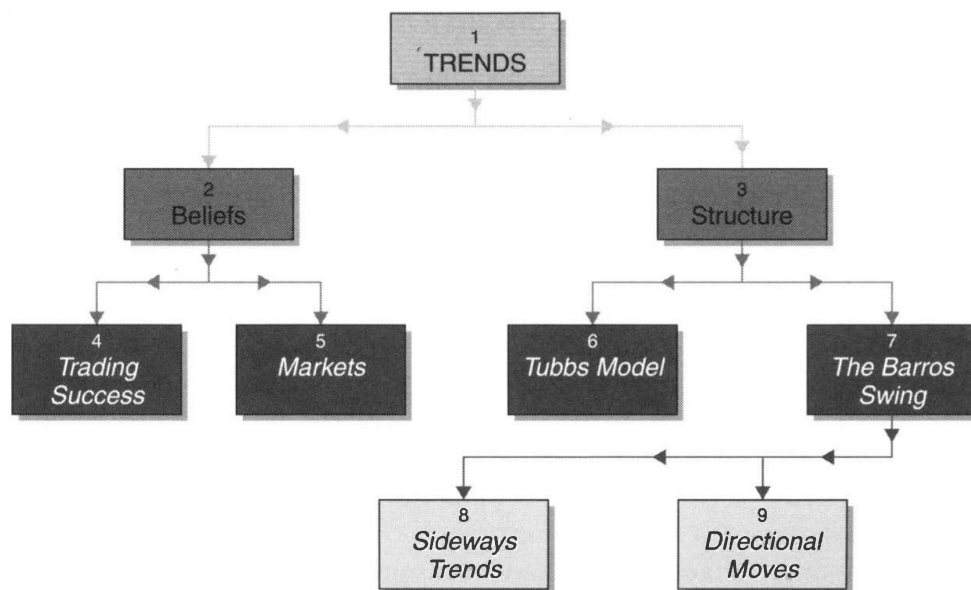


FIGURE 1.1 Pictorial Road Map of Chapter 1

2. We will then take an in-depth look at the structure and nature of trends.
3. Finally, we will see how the Barros Swing helps us identify not only the nature of a trend, but also its time frame.

MY BELIEFS ABOUT THE RELATIONSHIP BETWEEN TRADING SUCCESS AND THE NATURE OF THE MARKET

Neuro Linguistic Programming, the psychology of modeling success, tells us we model success by replicating three aspects:

- beliefs;
- states; and
- mental strategies.

The key to understanding my approach to trading is to understand each of these components and the way they interact. We will examine each concept as we proceed through the book. For now, let's take a glimpse at some of my beliefs—first about trading success and then about markets.

My Beliefs about Trading Success

Trading success has proven elusive for most market players. When I first joined the game in the late 1970s, the focus was on having the right plan; then money management was all-important; lately, psychology has taken center stage. Yet, as the following formula illustrates, all three elements are essential if we are to attain our trading goals.

Winning Psychology × Effective Money Management

× A Trading Plan with an Edge = Trading Success

How do these elements assist the trader? As traders, our psychological state, or mental mind-set, can lead to consistent profitability; our money management ability determines the size of our position and bet size; and our trading plan delivers the edge, defining how and when that edge occurs. We won't be dealing with psychology and money management in this book. Instead, we will focus on the trading plan.

A plan represents the means of weaving a path through the jungle that is the markets. There are as many successful plans as there are individual personalities. What is important is that the plan and personality form a whole. Since the plan needs to fit the trader's personality, traders have the option of using a fundamental or a technical approach. If we adopt the latter, we are faced with choosing between a mechanical approach and a discretionary one. As the differences are important, let's consider them now before we go any further.

The Mechanical Trading Approach

The mechanical trading approach has the following characteristics:

- The mechanical trader seeks to exploit “angles”—or, as Pete Steidlmayer called them, “behavioral parameters.” These market patterns deliver profits over a large sample size but have a use-by date. We’ll examine why in the next section.
- A mechanical method generally ignores the context of a trade.
- Generally, the mechanical trader limits his or her plan’s inputs to a maximum of three. (Some mechanical traders seek to optimize the inputs on an instrument-by-instrument basis, but I believe that the more robust plans have the same variables across markets and time frames.)
- The mechanical trader exercises his discretion and creativity at the design stage of his plan. Once the plan is formulated, the mechanical trader will “see a trade, take a trade”; in other words, he will take every trade that meets his plan’s criteria; he’ll take every trade irrespective of how he feels about its “correctness”; he’ll take every trade simply because his plan calls for the trade.

The advantage of the mechanical trading approach is that we learn to execute consistently. We take every trade, without hindering our execution with fear or hope.

The Discretionary Trading Approach

The discretionary trading approach has the following characteristics:

- The discretionary trader usually has a model of markets that accords with reality; in other words, his holistic plan has an edge. This advantage is a result of a set of beliefs that represents market behavior sufficiently well to deliver profits over time.
- The discretionary trader adopts a model that is based on principles or laws that are enduring. Examples of discretionary traders include: Richard Wyckoff, Charles Drummond (P&L Dot), Peter Steidlmayer (Market Profile), George Soros (Reflexity), and Joseph Hart (Trend Dynamics). These traders span a period of almost 100 years. While their theories and models may differ, they have in common a number of basic principles that remain true today. One common principle running through all the models is “context.” The context in which an event occurs is of extreme importance to the discretionary trader. For example, the DOJI is a pattern that suggests balance. (In this chart pattern, the open and close are in about the same place; often the range of the bar is smaller than normal.) After a directional move, a DOJI may signal a change in trend, or at least a correction. On the

other hand, a DOJI appearing in the middle of congestion has little probative value. A subjective trader will consider where the DOJI occurs—for him, context is everything. When he sees a DOJI, he considers the context and then proceeds to draw certain conclusions. The mechanical trader is less likely to ask about the context in which the DOJI appears.

- The discretionary trader may not take a trade just because the plan calls for it. How he feels about the trade is also important, as are other areas of discretion, such as position size, bet size, and the relative importance of various variables. In other words, both the right brain and the left brain need to align.
- Whereas the objective trader limits the inputs to no more than three, the discretionary trader may revel in a much larger array.

The advantage of the discretionary trading approach is that it mirrors the fluidity of the market, and we therefore expect the competent discretionary trader to have a better risk/return ratio than the competent mechanical trader.

Those are my beliefs about success. Now, let's examine my beliefs about the nature of markets.

My Beliefs about the Nature of the Market

Sir Isaac Newton's natural laws have been overturned by the theory that governs any free market, Complexity Theory—where "certainty" has been replaced by "chaotic probability." While a detailed examination of this fascinating theory is outside the bounds of this text, we need at least to mention the tenets that apply to the markets:

- There is order behind the apparent randomness of the markets.
- This order is fractal in nature—that is, we see the same patterns in all time frames, from the lowest to the highest.
- We can determine the probability of an occurrence over a large sample size, but we are unable to determine the result on an event-by-event basis. Mark Douglas identified this critical paradox. On a trade-by-trade basis, the market is uncertain and unpredictable; yet, over a large sample size, it is reflectively certain and predictable.
- Complex systems are self-learning. This characteristic explains why mechanical "angles" have a use-by date.

These tenets have important implications for both the mechanical and the discretionary trader. For the discretionary trader, they dictate the starting point for his model; that is, they define his view of the structure of the market. A trading structure needs to follow the basic tenets of the theory. And my model does just that, despite my not having heard of Chaos Theory or Complexity Theory when I first adopted it.

Let's look at the structure I adopt. It's a classic one, and has been around since *Tubbs' Stock Market Correspondence Lessons* (1941).

THE STRUCTURE OF THE MARKET

The Tubbs Model

The Tubbs Model, shown in Figure 1.2, gives the trader a road map of market activity as it proceeds from an uptrend to a downtrend, from downtrend to uptrend, and so on. As internalizing its characteristics puts the probability of success in our favor, let's review its essential traits.

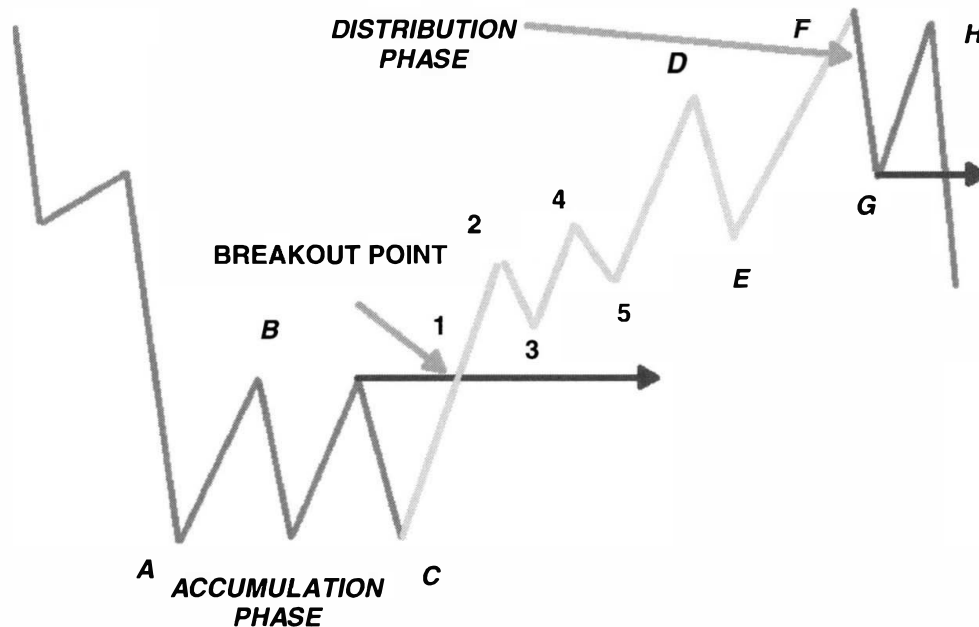


FIGURE 1.2 The Tubbs Model

After a prolonged bear market, there is a period of accumulation. Figure 1.2 marks this period A/B/C. At 1 we have a breakout and the first confirmation that a new bull market may begin. The breakout point is a bifurcation point in Complexity Theory—at 1 the market can either confirm the new bull trend or re-enter congestion.

Once the bull market gets under way, we can divide its movements into three sub-structures: up moves; down moves; and sideways, or horizontal, moves.

- The up moves gain more ground than the down moves. In an uptrend, the up moves are called an “impulse,” while the down moves are called a “correction.” In Figure 1.2, waves 2, 4, D, and F are impulsive, and waves 3, 5, E, and G are corrective.
- Similarly, in bear markets, down moves are “impulsive” and up moves are “corrective.”
- Moves that make no new ground and merely oscillate around a central price are called sideways, or horizontal, trends. In sideways trends, highs and lows are about equal.

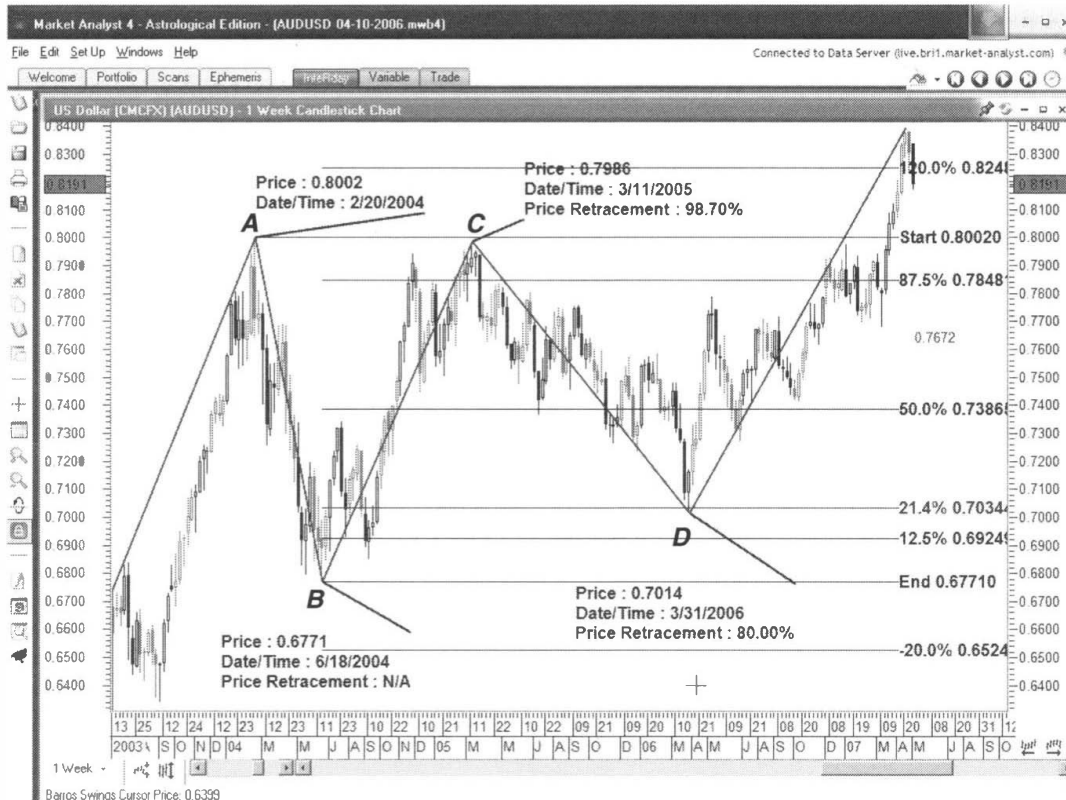


FIGURE 1.12 Weekly ADUS Congestion Formation: II

Source: Graphics used with permission from *Market Analyst*.

- The market dropped to the 80% retracement area and turned up. At the time of writing, it had broken above the upside maximum extension at 0.8248.

When I first started trading, I failed to appreciate the importance of identifying sideways markets and the need for different trading strategies for congestion markets than for trending markets. One event is imprinted in my memory. It was a Friday and I'd had a pretty good week of day trading. Chrisy, my wife, suggested I give trading a miss that night because I looked like a "car with no petrol in the tank"; and truth be told, I *was* tired. But hey, hubris set in and I figured I could rest on the weekend. Well, the S&P didn't do too much that night. My journals say it had a 6-point range. But my equity sheet showed I managed to lose 39 points! I succeeded in buying every high and selling every low.

It was only after my first workshop with Pete Steidlmayer on the Market Profile that the pennies started to drop. So, guys and gals, learn the lesson well.

Let's move on to trending markets.

Directional Moves: Uptrends and Downtrends

Uptrends have higher highs and higher lows; downtrends have lower lows and lower highs. The question arises: How many higher highs for an uptrend and

how many lower lows for a downtrend? I prefer to see at least two higher highs for an uptrend and two lower lows for a downtrend. For an uptrend, if I see only one higher high and higher low, I rate that as only a "potential uptrend." Naturally, in a downtrend, I want to see at least two lower lows; one lower low, lower high... I rate a potential downtrend. This is a general principle that I may modify, depending on the context. For example, if the market has been congesting for some time, I am more inclined to accept a breakout.

Figure 1.13 shows the Dow as it broke out of its multi-year congestion in 1984. *All swings within A/B are inside swings and can be discounted.*

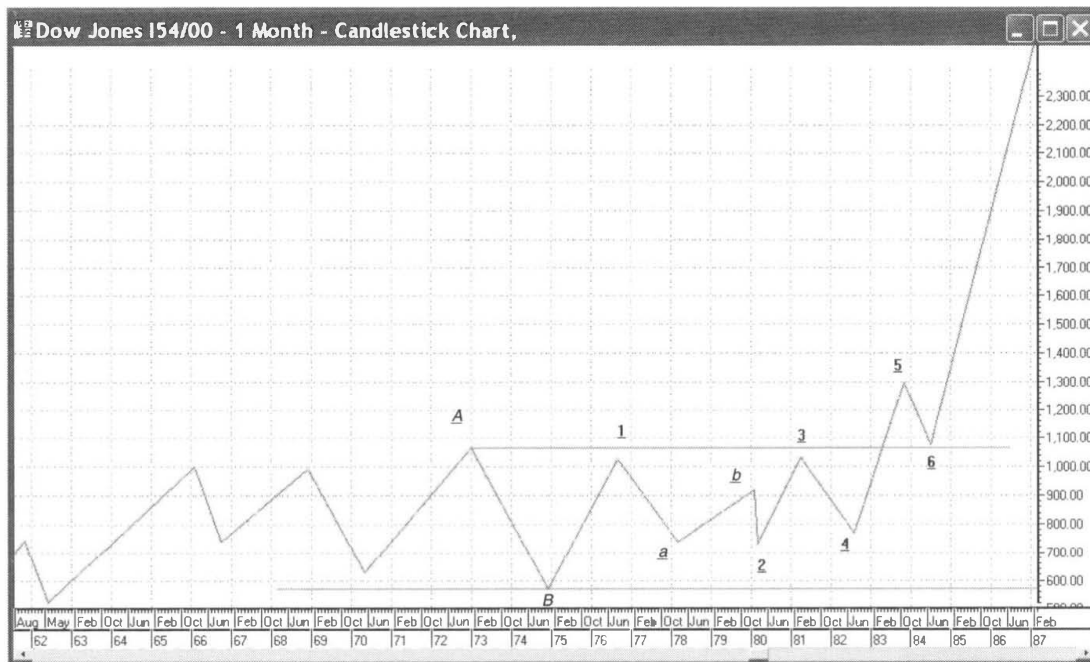


FIGURE 1.13 Dow Jones Industrial, Cash, Monthly
Source: Graphics used with permission from *Market Analyst*.

At 5 we have the breakout, followed by the classic re-test at 6 of the breakout level. At the re-test at 6 I would have rated an uptrend as probable.

In Figure 1.14, we have a weekly chart of the Dow in its 2003 breakout after 35 weeks of congestion.

I would rate this breakout only as a *potential* uptrend. We have one higher high, and a higher low is still to form. In addition, the first eight weeks of the breakout resulted in a one-week sideways move. Finally, even after the one-week uptrend commenced, the gains haven't been in keeping with a move preceded by a 35-week congestion.

What do I mean by a one-week sideways move? I mean that a Barros Swing of a one-week magnitude defines the sideways move.

The swings in Figure 1.15 are of a one-week magnitude. I have defined the congestion after the breakout with the labels 1/2 and have drawn in the horizontal channels. The chart is current to date of writing, and I believe the price

Change in Trend Patterns

INTRODUCTION

In Chapter 1 we examined ways of identifying the trend of a time frame. I started with trend identification because, by identifying the trend, we place the probabilities of success in our favor. For this reason, recognizing the trend forms the most important part of my analysis. If I get that right, then a successful trade will usually follow. In relation to trends, Pete Steidlmayer used to ask:

1. *What's the direction? And*
2. *Will it continue or change?*

We examined the direction of trends—up, down, and sideways (or horizontal)—in Chapter 1. More importantly, in that chapter we noted the important principle that **trends are linked to a time frame**. So, the first question above should be rephrased as: *What's the trend of the . . . [time frame]?*

For example, *What's the **monthly** trend?*

In this chapter, we will attempt to find ways to answer the second question: *Will it continue or change?*

The pictorial road map depicted in Figure 2.1 shows the main trend patterns discussed in this chapter.

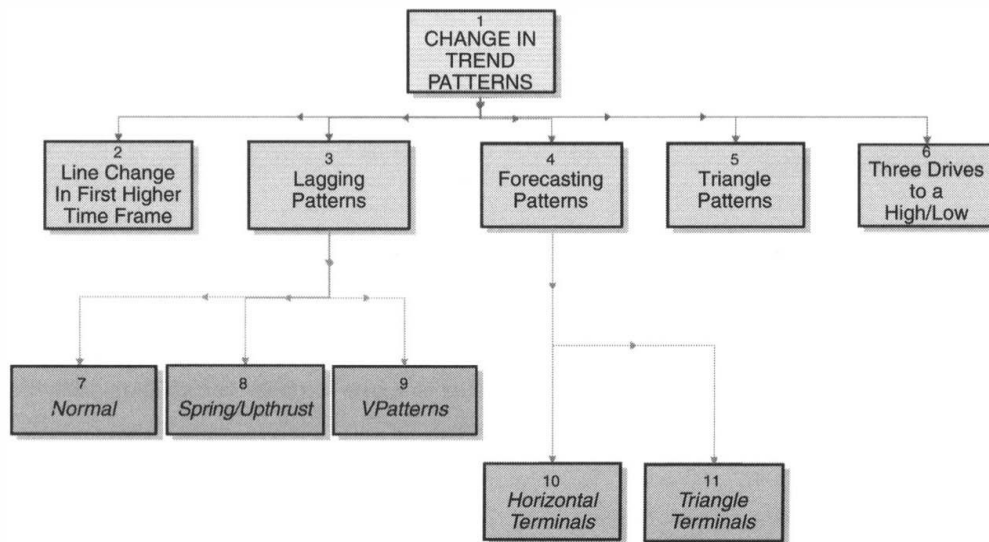


FIGURE 2.1 A Pictorial Road Map of Chapter 2

Let's first review the process for a change in trend. To change from an uptrend to a downtrend, we must first have acceptance of prices below a prior swing low and then have a series of lower lows and lower highs. A breach of the prior low will end the time frame's uptrend, but *a downtrend doesn't commence until we get a series of lower lows and lower highs*. Figure 2.2 illustrates the change in trend road map from up to down. The reverse is true for a change in trend from down to up.

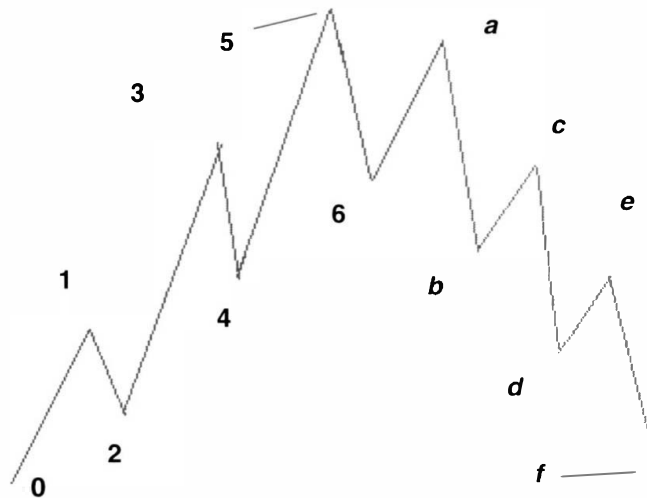


FIGURE 2.2 Uptrend and Downtrend Sequence

In Figure 2.2, the waves labeled with numbers (except 6) form part of the uptrend; those labeled with letters (and 6) form part of the downtrend. We don't have a confirmed change in trend (from up to down) until *d*, when we form a series of lower lows and lower highs (*a* to *d*).

Does this mean that we have to wait for a staircase pattern before we change our strategy? If I were a trend follower, then the answer would be an unequivocal "Yes!" But I don't believe we have to wait for the staircase structure in order to trade the change in trend. I say this because we have at our disposal certain high-probability patterns that enable us to anticipate a change. I have classified the patterns as follows:

- *Change in the first higher time-frame line direction:* This will occur every time there is a change in trend.
- *Lagging patterns:* One of these will be present in 92% of changes in trend.
- *Forecasting patterns:* These take place in the first lower time frame but forecast a change in trend in the trader's time frame. *What does this mean, you ask? Let's look at an example.*

If we are trading the 18-day (monthly) trend, the pattern will appear in the first lower time frame, the 5-day (weekly). But here is the critical point: *Although it takes place in the 5-day time frame, it has implications for the 18-day trend!*

Acceptance, and the Function and Impact of Time Frames

In Chapters 1 and 2, we learnt to identify the trend and when it changes. In both those chapters, the concept of acceptance of price levels figured prominently. In this chapter, we study this idea and the function and impact of time frames (see the pictorial road map in Figure 3.1).

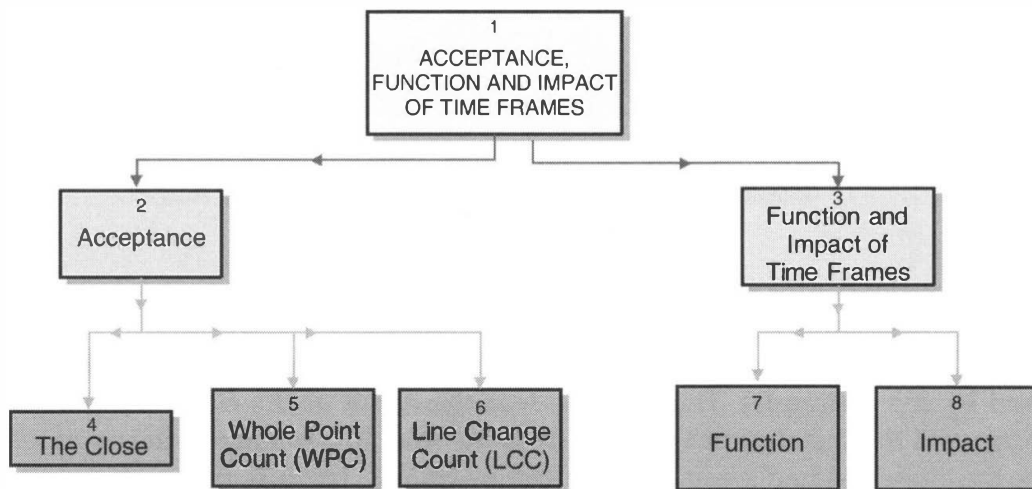


FIGURE 3.1 Pictorial Road Map of Chapter 3

ACCEPTANCE

Introduction

I learnt from Pete Steidlmayer that, with one exception, the fact that prices trade at a certain level is less important than what happens at that level (that is, rejection or acceptance). For example, compare the prices of the DJIA in Figure 3.2; in particular, compare the prices between 8,295 and 8,500. I have marked the areas with rectangles.

On both days, the market traded at the 8,295–8,500 level. Yet, there is a world of difference between the days. On August 14, I would say there was *rejection* of the level; whereas on September 3, there was *acceptance*.

You might ask: “What’s the difference?” I would respond: In August, I would expect prices to head higher the next day—that is, make a higher high and higher low, and to close higher (*rejection of the level*); whereas in September, I would

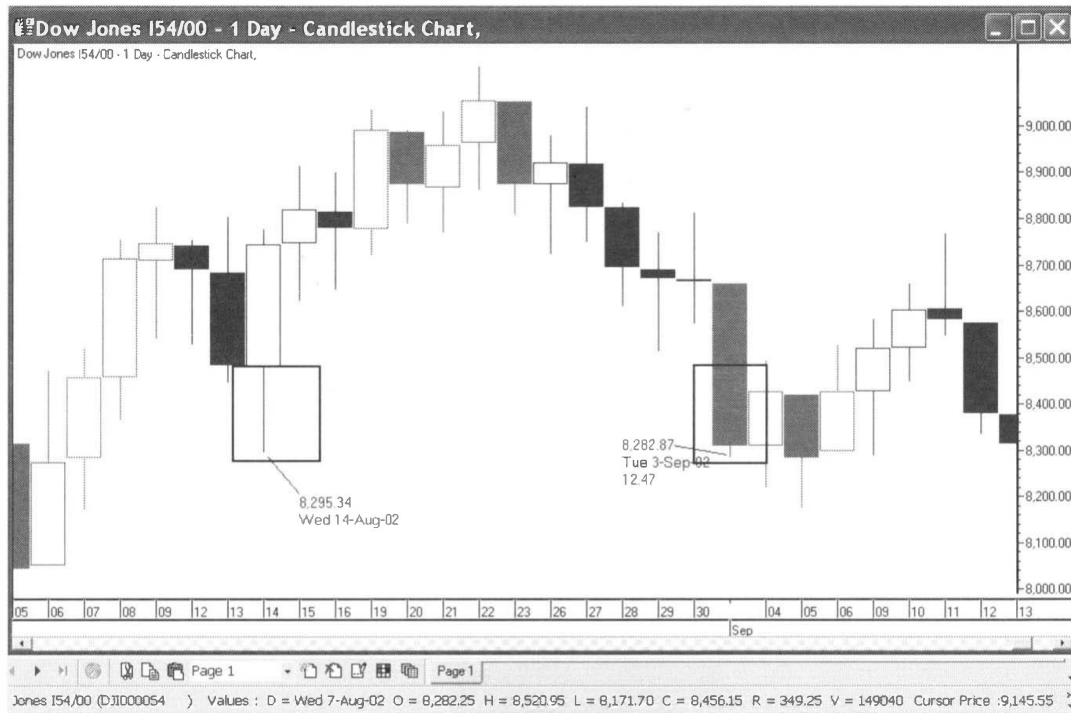


FIGURE 3.2 DJIA, Cash, Daily

Source: Graphics used with permission from *Market Analyst*.

expect the reverse—for the market to have a lower high and lower low, and to close lower (*acceptance of the level*).

I take this view because, in August, we have a long buying extreme (the area marked by the rectangle). The extreme was the result of the close being above the open and the distance of the open from the low. In September, the open was above the close and had a small buy extreme—that is, because the market closed on its lows, the distance between the close and the low was small. In short, the tools I used were the relationship between the open and close, and the magnitude of the buy and sell extremes.

The distance between the close and the open tells us whether the bulls or bears won the day:

- The open above the close is a victory for the bears.
- The open below the close is a victory for the bulls.
- The difference between the two tells of the magnitude of the victory: the greater the magnitude, the greater the probability of a follow-through the next day.
- The extremes tell us how much ground the bulls or bears lost during the day. Where the open is below the close (bull configuration), the buying extreme is the difference between the open and the low; while the selling extreme is the distance between the close and the high. Where the open is above the close (bear configuration), the buying extreme is the difference between the close and the low; while the selling extreme is the difference

Derivative Indicators

INTRODUCTION

By now you will have gathered that I consider identifying the trend, and the change in trend, as the most important part of trade preparation. You also understand that a change in trend in one time frame is merely a correction in the next higher time frame. This distinction is particularly important if you are a responsive trader—one who buys on dips in uptrends and sells on rallies in downtrends.

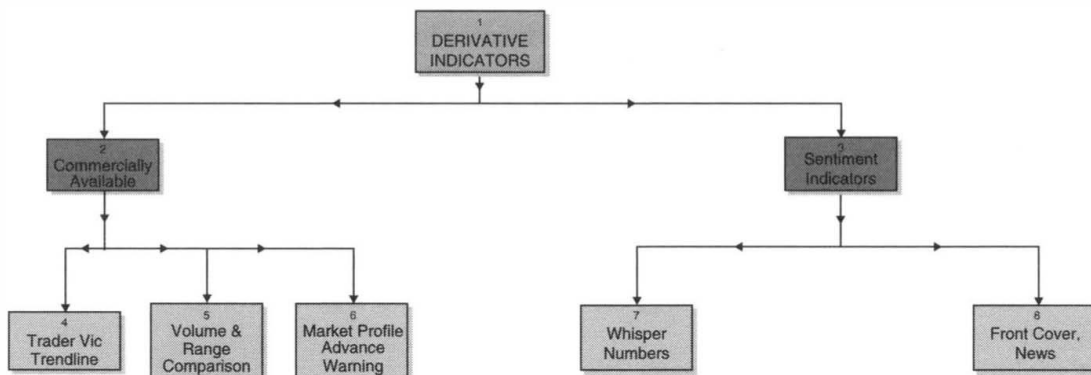


FIGURE 4.1 Pictorial Road Map of Chapter 4

But what about derivative indicators such as Wilder’s RSI? Do they have a place in my toolbox? The answer is: “No.” I consider the Barros Swing and Change in Trend Patterns to be primary tools. The tools discussed in this chapter are secondary tools. The distinction is important.

- A primary tool can be *the only reason* for a trade. That is, it is capable of justifying a trade on its own.
- A secondary tool increases the probability of success, but cannot be the sole reason for a trade.

For example, if I saw a Spring, I would take the trade whether or not a secondary tool were present; but a secondary tool alone, such as a Value Chart divergence, would need the support of a primary tool to justify the trade. To raise a rating from “normal risk” to “above normal risk,” I would want to see more than one secondary tool supporting the primary tool.

The various tools can be classified as follows:

- Tools that are available in commercial charting packages:
 - Trader Vic Trendline;
 - comparison of volume and range between two impulse moves; and
 - Market Profile AdvanceWarning Tool.
- Tools that require subscription to a service: Sentiment Indicators:
 - WhisperNumber;
 - Bullish Consensus; and
 - Front covers of popular magazines and responses to reports.

COMMERCIALLY AVAILABLE TOOLS

Trader Vic Trendline

Construction

Construction of the trendline is straightforward.

- *In an uptrend:* Draw a line from the lowest low to the swing low *preceding the highest high*. The line shouldn't pass through any low until after the highest high is formed. If the line does cut across other swing lows, select a nearby low so that prices remain above the trendline.
- *In a downtrend:* Draw a line from the highest high to the swing high *preceding the lowest low*. The line shouldn't pass through any high until after the lowest low is formed. If the line does cut across other swing highs, select a nearby high so that prices remain below the trendline.

Let's take a look at a few examples.

Figure 4.2 shows the correct Trader Vic Trendline drawn across the lows labeled "0/1." From "0/1" the trendline remains under all other lows. Note that *X* and *D* are the actual swing lows, but that I used 0 and 1. Look at what happens when the *X/D* lows are used.

As Figure 4.3 shows, the trendline passes through a number of lows—after *X* and after *D*! In fact, you will find that a trendline drawn from any low other than 0/1 will cut across other lows. In this case, the only correct trendline is the one drawn across the 0/1 lows.

Application

I use the Trader Vic Trendline in conjunction with a Normal Change in Trend pattern.

A Normal Change in Trend pattern that has had its Trader Vic Trendline breached has a higher probability of proving true than one whose trendline is intact. In fact, if a Trader Vic Trendline is breached, I am willing to consider fading the extremes of the congestion rather than waiting for acceptance beyond *B*. To pre-empt the trend

Entry and Trade Management

INTRODUCTION

In the previous chapters, we considered the trend of a time frame and whether the trend would continue or change. In this chapter, I will examine the requirements for a low-risk entry and trade management (see Figure 5.1).

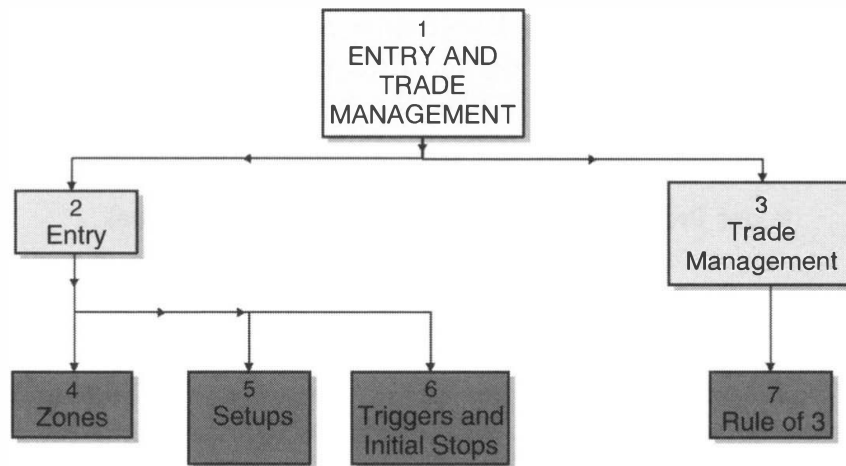


FIGURE 5.1 Pictorial Road Map of Chapter 5

Most novice traders make two critical trading mistakes:

1. They fail to consider the trend of their trading time frame, and whether it is likely to continue or change.
2. Once they have entered a trade, they fail to manage it.

In effect, newbies seek to make money without asking themselves how best to do that. Experienced traders do this by addressing the trend and management of the trade. In this way, they maximize their profitability by addressing both their entry and exit.

Newbies focus on having a high win rate. Because trading is a probability game, profits and losses are randomly distributed; on a trade-by-trade basis, the trader has no direct influence on his or her win/loss rate. Entries and exits are a wholly different matter: the trader has a direct controlling influence. In fact, the entry and exit are the only elements in a trader's trading plan that are within his or her total control.

To overcome the probability hurdle, traders can adopt one of two strategies: they can opt to be always in the market; or they can identify those conditions that produce optimal results for their trading style and personality.

In my trading, I adopt the latter course. To place the probabilities on my side, I seek certain requirements before I take a trade. Once I have determined the trend questions, the first requirement for entry is a statistical "Time and Price Window." Within that window, I look for support (when buying) or resistance (when selling) based on MIDAS and Fibonacci ratios.

The market needs to approach my zones and provide a pattern that tells me the support or resistance has proven effective. I call these patterns "setups." Once a setup is complete, I look for the entry pattern in the second or third lower time frame. Because my trader's time frame is the 18-day, my entry is based either on a daily bar or a bar based on the following formula:

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Once I determine how and where I will enter a trade, I determine where my initial stop is to be placed. I then decide if the risk/reward ratio is within my money management guidelines. I calculate the risk/reward ratio by assessing the following:

$$\text{(Core Profit} \times \text{WinRate)} / \text{(Initial Stop} \times \text{LossRate)}$$

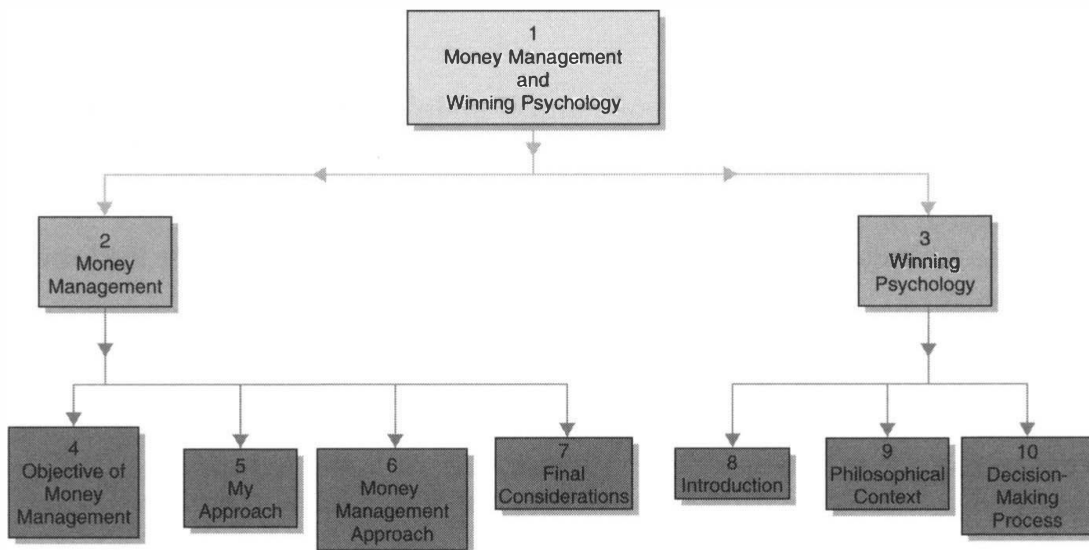
Where:

- *Core profit* is the target for the "core contract profit." We will discuss the core contract profit in the section below dealing with the Rule of 3.
- *WinRate* is the historical win rate (Winning trades/Total number of trades).
- *LossRate* is the historical loss rate (Losing trades/Total number of trades).

I like to see a risk/reward ratio of around 2:1. In my own trading, I find a risk/reward ratio of 2.5:1 difficult to maintain. Historically, my risk/reward ratio is between 2:1 and 2.3:1. Each trader should keep his own set of trading results that will allow him to work out his historical risk/reward ratios.

The initial stop is the first step in the trade monitoring process. This is a quantitative step, representing a financial loss beyond which I'm not prepared to continue, and its placement is chart-based. I bypass the trade if the loss involved is greater than my money management rules allow.

Effective Money Management and Winning Psychology



INTRODUCTION

Effective Money Management and Winning Psychology have a place in every trading book; and this is no exception. Indeed, these topics ought to be the subject of their own book. Why should this be the case?

In the success formula:

$$\text{Winning Psychology} \times \text{Effective Money Management} \\ \times \text{Plan With An Edge}$$

Winning Psychology represents 60% of the equation and Effective Money Management 30%. So it is tempting to think that we can succeed without a Winning Plan With An Edge. In recent literature, I have read gurus who believe that random entry and exit will make money as long as we have Winning Psychology and Effective Money Management. In my view, nothing could be further from the truth.

MONEY MANAGEMENT

A plan without an Edge that is executed with proper money management will allow us to survive the game a little longer, or perhaps a lot longer. But money management alone will not turn a plan without an Edge into a winner. Notice that the formula contains a multiplication sign between each of the elements so that a zero for any of the elements will mean that the total is zero.

What is this "Edge?" It is a Winning Plan that, over a large sample size, gives us a return of capital greater than \$1 for every \$1 of risk. The edge is calculated with the formula:

$$(\text{Average \$ Win} \times \text{WinRate}) - (\text{Average \$ Loss} \times \text{LossRate}) = >1$$

Where:

- The Average \$ Win is the total number of dollars won divided by the total number of winning trades.
- The WinRate is the total number of winning trades divided by the total number of trades.
- The Average \$ Loss is the total number of dollars lost divided by the losing trades.
- The LossRate is the total number of losing trades divided by the total number of trades.

Successful traders know that focusing on raising the WinRate for position trades to more than 60% is an exercise in futility or better left to those trading geniuses that inhabit the earth on rare occasions. For mere mortals, like you and I, a WinRate of 45% to 55% is what we can expect to achieve. The difference between the losing newbie and the experienced successful professional is the difference between the average dollar win and the average dollar loss. For most professionals, this difference can be as much as 3:1 and 4:1. In this way, we can have a hit rate of 45% and still have an excellent return.

That gives you the Expectancy Return, which is a function of a Winning Plan. So, what is the function of Effective Money Management?

It is to balance the opposing aims of maximizing profitability on our capital and preventing the risk of ruin. The risk of ruin means losing so much money that we can no longer be in the game. Most newbies fail to appreciate the importance of risk of ruin; yet its appreciation is paramount to our success. If we have US\$100,000 to invest and we risk only US\$100 per trade, then we are underutilizing our capital. On the other hand, if we were to risk the whole US\$100,000 each time we traded, then sooner or later, we will suffer ruin.

Objective of Money Management

To get a clear idea of the balancing act in money management, you need to ask these questions:

- What is the maximum amount that I should risk per trade?

Barros Swings in Action

INTRODUCTION

For me, this is the fun part of the book. The basics have been covered: we have learnt to identify the trend, and a change in trend, for a specific time frame; we have also had a look at some secondary tools. In this chapter, by analyzing the price action of a couple of instruments, we will see the Barros Swings in action. The market action is current at the time of writing.

The following process is derived from the theory of immersion. If you diligently apply the procedure, you will exponentially increase your learning curve.

For the purposes of the examples, we will assume that your trader's time frame is the 18-day. The method consists of:

- answering the questions in sequence;
- making a note of the answers; and
- reviewing your decisions weekly and monthly, to ensure that the lessons you have learnt become second nature.

Starting with the first higher time frame, in this case the 12-month swing, the first questions you need to ask are:

1. *What is the line direction?*
2. *Where are the 12-month support and resistance levels?*
3. *Is the line direction likely to continue or to change?*

Next, shift to the second lower time frame, in this case the 13-week swing, and ask:

1. *What is the trend?*
2. *What is the line direction?* Note that there is a difference between line direction and trend direction. A line direction is merely a swing direction in an ongoing trend.
3. *Is the trend and/or line direction likely to continue or to change?*
4. *Where are the 13-week support and resistance levels?*

Strictly speaking, the next time frame is the 18-day; we are looking either to trade in line with its trend or for a trade that involves a change in trend. As the 18-day line or trend approaches the 12-month and 13-week support or resistance levels, we want to see if it is likely to respect the zones or whether it will continue its line direction.

On most occasions, an 18-day line change will be signaled by a 5-day change in trend. So, we will examine the 5-day swing and see how it is reacting to the higher time-frame support or resistance areas.

For the 5-day line trend, ask:

1. *Do we have a change in trend pattern?*
2. *Does a comparison with the previous impulse swing indicate continuation or change?*

Once we have covered the 12-month, 13-week, and 5-day, we have created a background for analyzing the 18-day.

1. *What is the current 18-day trend?*
2. *Is the trend in its infancy or is it mature? At this stage, we answer this question by using the breakout point as a reference point. If the market has just signaled a change in trend with a Whole Point Count (WPC) and Line Change Count (LCC), it is in its infancy.*
3. *Is the trend likely to continue or to change?*
4. *Is the 18-day momentum indicating trend continuation or change?*
5. *Are any potential changes in trend patterns unfolding?*
6. *If the current line is moving against the 18-day trend, ask questions 2 to 5, as well as:*
7. *What are the 18-day support or resistance zones?*
8. *How is the 3-day reacting to them? Here we are looking for clues that will tell us if the 5-day impulse move (18-day correction is the same as a 5-day impulse move) is coming to an end.*
9. *Is the 3-day momentum indicating 5-day continuation, or change in the 5-day line direction?*
10. *Are we seeing climactic volume and range? (By "climactic," I mean in the third standard deviation. This suggests that a change in trend is imminent as evidenced by a change in trend pattern.)*

After we have gathered the information, we summarize it and use it to create a plan of action. This plan includes a description of price action that tells us revision is necessary.

Let's have a look at a few real-time examples. We'll start with the Dow Jones Industrial Averages (DJIA).

We can say that the range 9,901 to 9,969 is resistance; another area would be the Primary Sell Zone of 10,285 to 11,438.

Five-Day Time Frame

1. Do we have a change in trend pattern?

Let's now turn to the 5-day to see if we can glean clues and tidbits on the possible 13-week line turn. Figure 7.7 shows that the breakout price action was composed of two 5-day congestion zones, A/I and C/F. At F we may have the start of an impulse move.

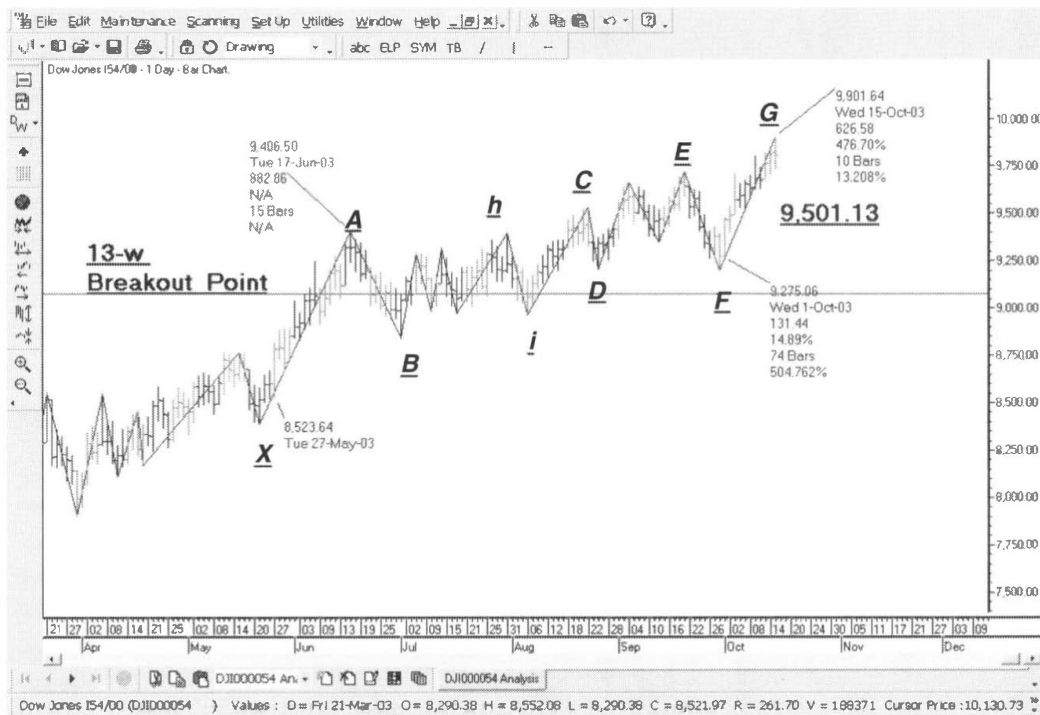


FIGURE 7.7 Dow Jones Industrial, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

2. Does a comparison with the previous impulse move indicate continuation or change?

The presence of two sideways structures on a breakout from a six-month congestion zone indicates a market in doubt: has a new uptrend really begun? To be convinced, traders and investors need to see a strong impulse move beginning from F.

How does the current impulse move from October 1, 2003 to October 15, 2003 (F/G) compare with the impulse move prior to the breakout (X/A)? (I chose X/A as it was the first impulse move prior to F/G.)

Figure 7.8 gives us the answer: the bars are "invisible," so you can read the statistical data.

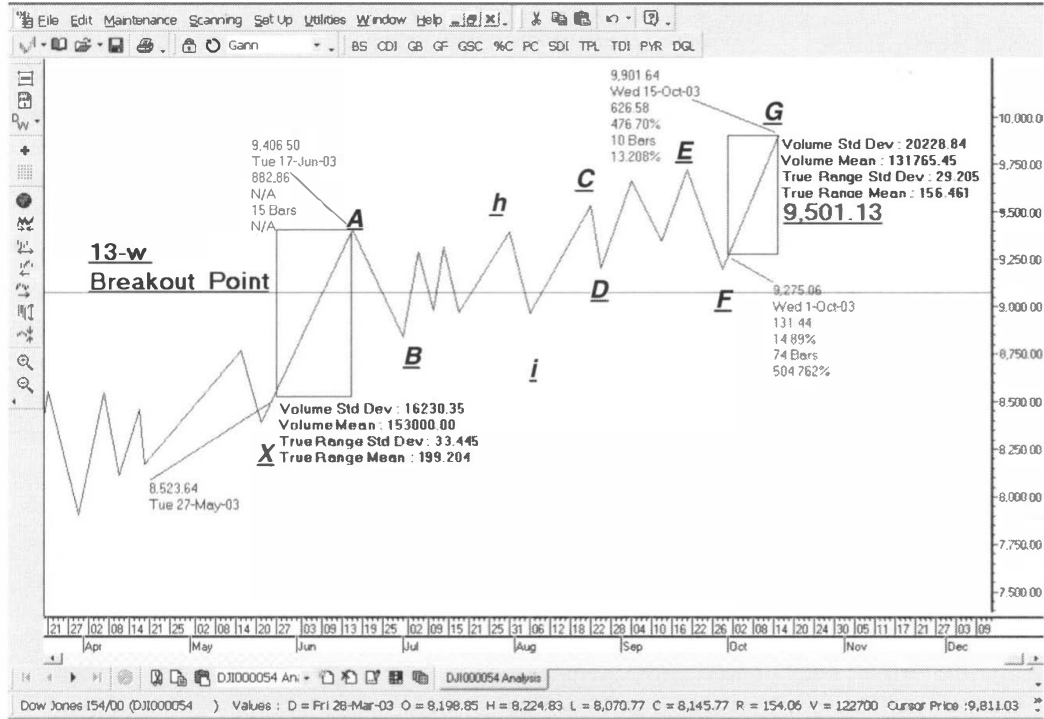


FIGURE 7.8 Dow Jones Industrial, Cash, Weekly
 Source: Graphics used with permission from *Market Analyst*.

The current upswing has reduced volume and range. In other words, this upswing has less momentum than the previous swing and suggests this market is “tired.”

After analyzing the 12-month, 13-week, and 5-day, we can draw the following tentative conclusions:

- The new 13-week uptrend is likely to remain intact until the market reaches the 12-month resistance zone of 12,854 to 10,896.
- The 13-week line is likely to turn down and test the 13-week band: from the breakout point at 9,076, to the Primary Sell Zone support at 10,285.

Eighteen-Day Time Frame

We turn now to the 18-day, where we will look for confirmation or negation of the tentative conclusions.

1. What is the current 18-day trend?

The current trend is a potential uptrend.

- Figure 7.9 shows the early Spring that forecast the low at *E*.
- There is a WPC and LCC, but . . .
- . . . the market still has to define a series of higher highs and higher lows.

Formulas for Constructing Barros Swings

The smallest swing in any time frame is the “one” period. In the Barros Swing, these are drawn differently than the other swings in the same time frame.

ONE-PERIOD SWINGS

To draw a one-period swing, start at an extreme low or high. For the purposes of this illustration, let’s assume we start from a low.



FIGURE A.1 Dow Jones Industrial, Cash, Daily
 Source: Graphics used with permission from *Market Analyst*.

In Figure A.1, let’s say we start the swing on March 12. From the low, we draw a line from its low and continue to do so until Friday, March 21. On Monday, March 24 we have a low below the previous day’s low. Accordingly, we draw the line down from the high of Friday to the low of Monday and continue to do so until we get a day where the high exceeds the previous day’s high. At that point, we draw the line up—and so on.

Inside days are ignored.

For outside days, the drawing of the line is delayed until the day following the outside day. If the high of the outside is exceeded, we draw the line up; if the low is exceeded, we draw the line down.

SWINGS FOR PERIODS GREATER THAN ONE

Three-Period Swing

Using the same data, we start from the low and turn the line up when *we exceed the highest high of the past three days (including today) +10% of the adjacent one-period swing*.

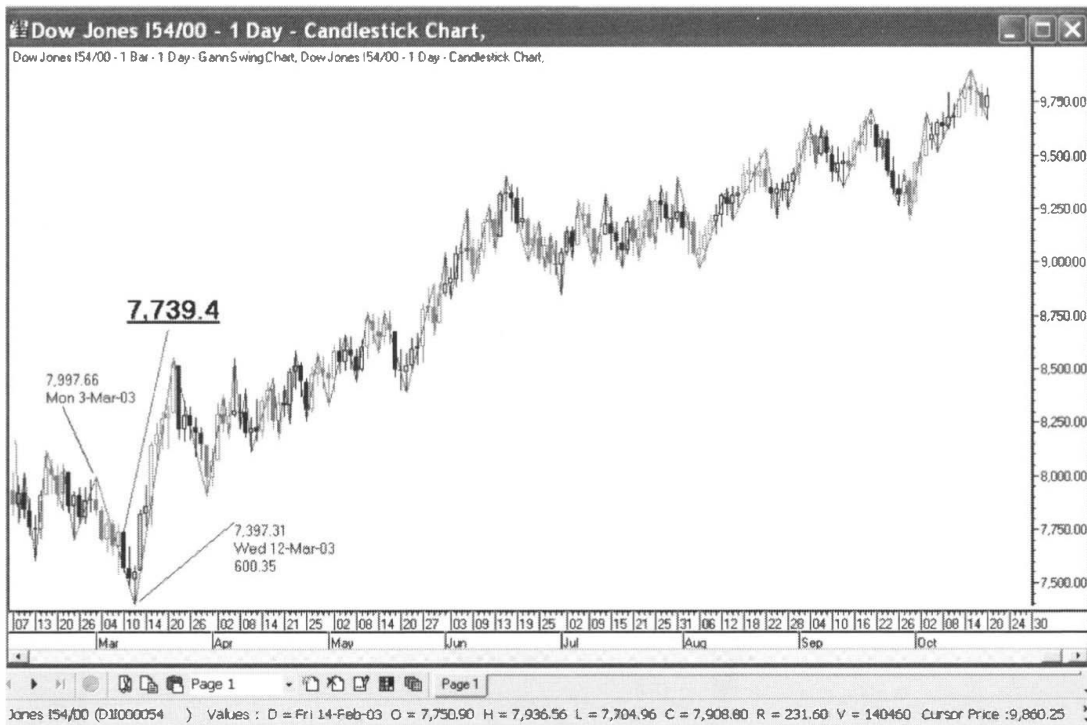


FIGURE A.2 Dow Jones Industrials, Cash, Daily
Source: Graphics used with permission from *Market Analyst*.

In Figure A.2, the lines represent one-period swings. At the completion of trading on Wednesday, March 12, the 3-day line will turn up on the breach of the highest high of the past three days (including today); viz, $7,739.4 + 60$ (10% of the one-period swing, which was 600.35 points). The line will continue up until the market takes out a low that is the lowest low of the past three days +10% of the adjacent one-period swing.

Reverse to turn the line down.