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Sidestep Those Losing Trades

Breakout Or Fakeout?

Trading "false breakouts" can be a costly mistake. Find out how you can minimize these types of entries using simple visual price action, volume, and volatility-scanning strategies.

by Ken Calhoun

It's the single biggest challenge a trader will face: you enter what looks to be a solid technical breakout trade, only to see it reverse course and stop you out. When this happens over and over, these false breakouts can quickly drain your trading account.

Two of the most common errors that active traders make include:

- Not using tight stops, which results in taking stop-losses that are too expensive, and
- Overtrading choppy charts with weak, uncertain technical entry signals. If you trade choppy, low-volatility charts, you'll likely have many stops and fewer winning trades.

Instead, knowing what specific types of charts to trade can put the odds in your favor, since strong breakouts often continue in-trend, when traded correctly. In this article, I'll show you how to minimize false breakout entries using simple, visual strategies that are based on price action, volume, and volatility scanning.

Minimum trading ranges

To avoid false breakouts, it's especially important for you to focus on trading only those stocks with high-enough volatility to make for a strong risk-to-reward ratio. For swing trading stocks, when scanning for what to trade, it's best to look at those priced between \$20–70 per share with volume of at least one million shares per day.

When looking at a chart that goes back 15 days, an important *minimum threshold* value for swing trading volatility is to only swing trade stocks that have at least a 10% range. For example, if you look at the 15-minute, 15-day chart of Progressive Corp. (PGR) in Figure 1, you can see the trading range is (\$27.80–31.40), or \$3.60 for a \$30-range stock, which meets the 10% minimum requirement. Note that in this chart, price is also in a strong, sustained uptrend.

This 10% minimum volatility guideline can help you avoid trading stocks that have false breakouts due to choppy, compressed trading ranges. Similarly, for example, a stock priced at \$50 per share would need to have a minimum five-point range (such as a 15-day low of \$45 per share and 15-day high of \$50 per share or higher).

When daytrading stocks, you should look for those priced \$20–70 per share that have at least a 1.5-point intraday average trading range, and at least 15,000 shares per minute in volume. You can see this illustrated in the one-minute, one-day chart of Paypal Holdings Inc. (PYPL) in Figure 2. To minimize false breakouts, it's best to focus on those that have an opening range breakout move of at least \$0.50–0.80.

The technical thinking behind using minimum trading ranges is well known to professional traders: highly volatile, strong-trending charts make for easier breakout entries. Wall Street traders say these types of charts are "in play," because strong buying volume is at work, lifting prices up to new highs.

Check this out for yourself: look at your most recent 20 or so stop-losses; you'll likely find most failed these simple "volatility threshold" tests.

Volume signals to avoid false breakouts

It's well known that high volume can be used as a momentum confirmation signal for entering new-high price-action breakouts. You may have often seen price move up

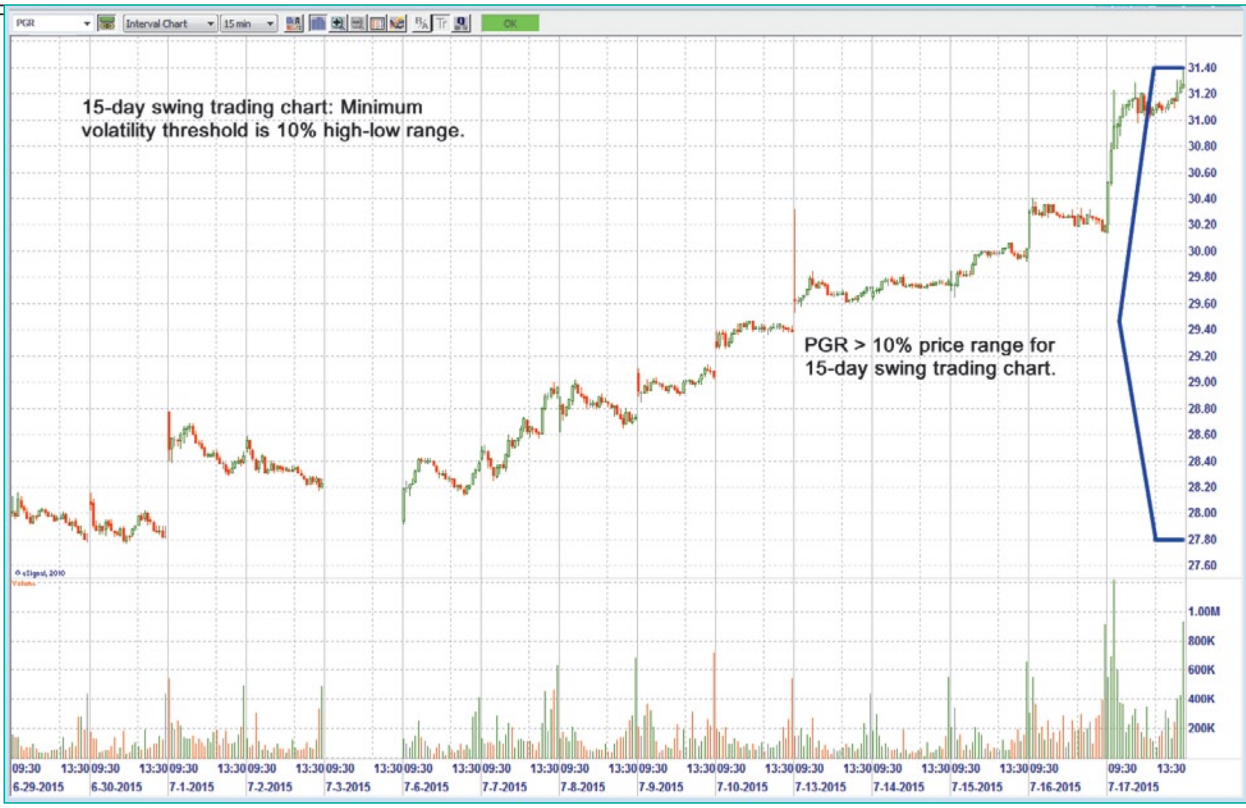


FIGURE 1: MINIMUM TRADING RANGES. A minimum threshold value for swing trading volatility is to only swing trade stocks that have at least a 10% range. Here you can see the trading range is from \$27.80 to \$31.40, or \$3.60 for a \$30-range stock, so this meets the 10% minimum requirement.

following a high-volume breakout in charts that you trade. However, false breakouts can also occur when volume and price are not quite strong enough to sustain a trend, leading to a price reversal.

If you look carefully at the volume bars in the daily chart of Eros International (EROS) in Figure 3 (it spans a period of 90 days), you can see how high-volume days subsequently lead to new price-action highs. Entering a swing trade on the days

FIGURE 2: DAYTRADING VOLUME & VOLATILITY. Here you see a strong opening breakout pattern on high volume. To minimize false breakouts, it's best to focus on those that have an opening range breakout move of at least \$0.50–0.80.

FIGURE 3: HIGH-VOLUME BAR BREAKOUTS. Here you see how high-volume days subsequently lead to new price-action highs. You can minimize false breakouts by waiting to enter until after high-volume bar days.

following high-volume days led to a continuous uptrend. Note that these "high-volume" bars are at least twice the height of the two to three days preceding each one. This exceptionally high volume led to uptrending continuation in price, avoiding false breakouts.

Three-phase channel trend breakouts

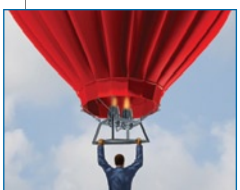
It's well known that 45-degree angle trends are often the strongest ones you can trade. To find these ahead of the move, it's helpful to look for steady, shallower-slope uptrend moves. These often then gain additional buying momentum, which

FIGURE 4: THREE-PHASE BREAKOUT CHANNELS. This three-channel pattern can help you find strong breakout entries.

makes for ideal trading charts, as you can see in the daily chart of DBV Technologies (DBVT) in Figure 4. The chart covers a period of 90 days.

This chart illustrates three major phases: the initial consolidation, an intermediate shallow-slope move, and then the strong 45-degree angle move. Each of these three major trend phases lasts for at least two weeks, providing plenty of opportunity to get into a trade. This progression from uncertainty to slow buying to accelerated buying is a pattern you can locate visually on many charts. It helps you find strong trade setups.

When looking to avoid false breakouts in your trading, careful visual scanning for this type of chart can make a significant positive impact when traded correctly. Developing pattern-recognition skills is often time-consuming; however, using the example charts I have shown can help you see what types of charts are the best to focus on.



Tape-reading breakouts for daytrading

When daytrading stocks, you can spot new breakout entries by following the time & sales transactions, using classic *tape-reading* tactics. I've used this approach when trading professionally for over 15 years and the core strategies remain unchanged. To avoid false daytrading breakouts, it's important to know when momentum is truly on your side, which is what tape reading accomplishes.

On the one-minute chart of Etsy, Inc. in Figure 5 (ETSY), you can see that price moved from \$17 per share to \$23.50 per share in a steady, sustained uptrend during two and a half hours. The main data to follow on the tape is price action, specifically how fast price goes up through each 10-cent increment. When looking for sustained breakouts, you may often see the transaction flow (or "patter") of the tape get faster and faster during a breakout rally.

The final clue comes from volume, that is, when institutional *block trades* (typically 1,000 or more shares per transaction) start showing up in the tape, as seen in Figure 5. This portion of the tape was captured at 10:01 am ET to illustrate how far price moved after this time, following the block trades that are shown.

Charts to avoid

Trading the strongest sustained-trend breakout charts can go a long way toward helping you avoid false breakouts. Too-cheap or too-expensive charts should be avoided, as should overtrading choppy charts. Here's what you should *not* trade:

- *Penny stocks (under \$5/share):* They're easily manipulated by unscrupulous front-running educators, vendors, and promoters alike. Stocks in the sub-\$5 price range should be avoided at all costs. Trading thousands of shares of wildly volatile charts in hopes of getting small wins is speculative gambling at best. Like a "lottery effect,"

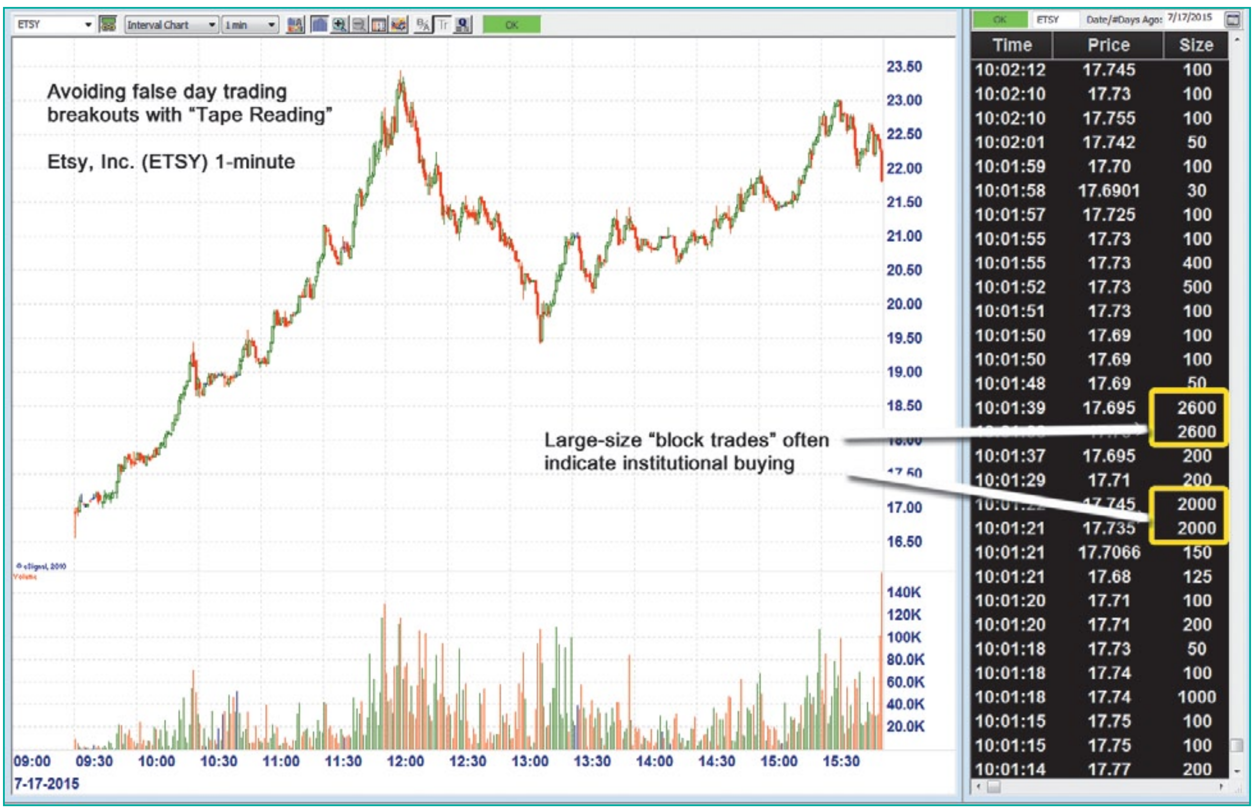


FIGURE 5: TAPE READING WITH BLOCK TRADES. The main data to follow in the tape is the price action. When looking for sustained breakouts, you may often see the transaction flow of the tape get faster and faster during a breakout rally. The final clue comes from volume. Large size "block trades" often indicate institutional buying.

the widely publicized rare penny stock wins are heavily outnumbered by average traders' substantial losses for these (which are not published). Pump & dump boiler room unethical behavior is rampant here from educators and promoters, since prices are easily manipulated.

- *High-priced stocks (over $100/share):* Unless a trader has a large six- or seven-figure trading account, the high flyers that trade well above $100 a share should be avoided. The risk–reward ratio and margin needed to trade these make them less than suitable for intraday and/or swing trading. The volatility is also lower, percentage-wise, than those stocks that are $20–70 per share with a 10% or better price range over a 15-day period, and this could potentially lead to more false breakouts. Further, trading highly expensive stocks ties up trading capital that can be put to better use by trading a more diverse group of stocks that are making new breakouts.

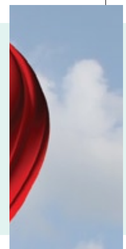
A BREAKOUT TRADING PLAN: SUCCESS TIPS

Another good rule to follow is to only enter trades when the S&P 500 (and the chart being traded) are both breaking out to a new two-day high. Trading entries on these "out" days usually produce better entries compared to entering on "in" days, where the market is inside the prior day's high–low range.

From a risk-management standpoint, it is wise to use no more than a $1.50–2.00 initial and trailing stop, combined with position sizing, or scaling (adding shares to a winning position every $2 or so during an uptrend, for stocks in the $20–70 per share range).

Professional traders can often be heard saying smart phrases like "tight is right" and "when in doubt, get out." Tight stops are the key to successfully trading breakouts. By making an effort to avoid false breakouts in your trades, combined with careful risk management, you can develop a more consistent, accurate trading approach.

Trading the strongest sustained-trend breakout charts can go a long way toward helping you avoid false breakouts.



Ken Calhoun is a producer of multiple trading courses, live seminars, and video-based training systems for active traders. He is a UCLA alumnus and is the founder of TradeMastery.com, an online educational site for day and swing traders.

FURTHER READING

Calhoun, Ken [2015]. "Gap Continuation Breakouts," *Technical Analysis of* STOCKS & COMMODITIES, Volume 33: September.

______ [2015]. "Trading With Price-Action Pivots," *Technical Analysis of* STOCKS & COMMODITIES, Volume 33: July.

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