Using Overthrow for Stop Placement

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Outline

Disclaimer

Neither this presentation, nor anything on my Twitter, Telegram, or any other medium/mode of communication, including private correspondence, constitute financial advice.

I am not a financial advisor and hold no formal qualifications in this area.

Trade entirely at your own risk.

This is for entertainment purposes only.

General Remarks

- This video builds on the concepts discussed in the S/R Setup video → recommended but not mandatory watching
- Two legs when looking at technical structure for a trade:
  - 1. Does the structure itself qualify?
  - 2. Does it allow you to define your risk i.e. somewhere logical to place a stop loss order?
  - There is nothing wrong with staying away from blindly trading a structure if it doesn't allow risk to be defined clearly, this video focuses on what to wait for in such cases
- Core premise: instead of having to choose a stop loss after deciding on a technical structure, sometimes the market does that for you → price action offers a 'built-in' invalidation level
  - Easier to identify
  - Easier to replicate
  - Removes/reduces discretion which makes collecting stats easier and the data itself more reliable

Markets Are Not Clean

- Common technical principles:
  - Support is support until it is broken
  - Once it is broken, it turns to resistance
- If this were true in (virtually) every case, losing money as a trader would be much more difficult
  - Buy support/sell resistance until it stops working
  - Once it stops working, close out and flip direction
  - <u>Unfortunately, this is a caricature of how markets operate</u>
- Breakouts fail, breakdowns fail, support/resistance flips fail, chart patterns fail, trendlines fail etc.
- Markets, particularly those heavily driven by speculation, necessarily reflect the fact that traders (technical or not) get caught offside and are <u>forced</u> to make a decision
  - This is why ‘trap’ setups tend to unwind in such a volatile fashion

Defining Risk at a Level

- Technical structure on its own, in my view, is not enough to warrant a trade setup
  - The structure must allow for logical stop placement
    - Ideally using a method that's objective and replicable i.e. has a reference point, as opposed to a 'floating' stop/fixed arbitrary value
- As mentioned, it is fine to avoid taking a trade at an otherwise compelling technical structure on the basis that it does not provide a way to clearly define risk
  - Or define risk in a way that offers adequate R:R (for that specific setup)
- Identifying technical structures is the easier part
  - Defining risk in a way that a) is logical and replicable; b) accurately invalidates the trade idea; and c) balances adequate R:R whilst not being a tight-arse, is the difficult part
- Options:
  - Wait for price to define risk for you (focus of this lesson)
  - Miss the trade
  - Price action-based entry (see: Entry Triggers video)
  - Enter at the next closest structure/break of FTA (probably a future video/article)

Overthrow I : Introduction & Explanation

- Definition: *when price exceeds a boundary of a technical structure and then falls back within it*
- Not some new, ground-breaking concept
  - False break, fakeout, bull/bear trap, deviation, pattern failure, reclaim etc.
- How does the whole technical trap/'traders forced to make a decision' argument apply to overthrow?
  - If a trader is offside on a trade (i.e. on the wrong side of the market, also colloquially known as 'underwater' on a position) they are forced to make a decision
    - Close at a loss
    - Do nothing (await stop out/liquidation)
    - Wait for market to revisit entry price to close at break even/reduced loss
  - If a lot of traders position the same way (e.g. selling a bearish pattern that's all over financial media) and the market takes them offside, as they 'puke' (i.e. close at a loss) their short positions at market, those closes become market orders to buy
  - High volume of market orders as traders puke + experienced traders taking the other side with size = volatility* → markets are often unforgiving; offside positions given little/no chance to mitigate

Overthrow II: Structures & Elements

- Definition: *<u>when price exceeds a boundary of a technical structure and then falls back within it</u>*
- Given that most technical structures have a boundary of some sort (including those painted by indicators e.g. Ichimoku Cloud) they are all prone to being overthrown
    - I have not studied indicator-based overthrow. I cannot see why the logic wouldn't apply to popular indicators, MA values, etc. which get just as crowded. I encourage independent research on this matter.
- Horizontal S/R
- Ranges
- Patterns
- Trendlines
- Market Structure
- Any/all their variants e.g. S&D zones etc.

Overthrow II: Structures & Ingredients

- Elements of overthrow
  - Clear technical boundary formed
  - Price closes through the technical boundary (ideally impulsively)
  - Price stays reasonably close to the breakout point
  - Price closes back within the technical boundary (ideally impulsively)
    - Doesn't have to occur immediately after the break
- The price movement beyond the range boundary is the overthrow portion → this is also the area that we will be using for defining risk
- Trades are taken in the opposite direction to the overthrow
  - E.g. failed break to the upside → price falls back within the breakout point → breakout buyers are the ones trapped → we look for short setups in anticipation that they are going to puke/unwind
  - E.g. failed break to the downside → price rises back within the structure → breakout sellers are the ones trapped → we look for long setups in anticipation that they are going to puke/unwind

Stop Placement I: Furthermost Deviation

- Definition: *risk defined by the highest high/lowest low made when price exceeded the technical boundary*
- Sell setup: risk defined by highest high made above the technical boundary
- Buy setup: risk defined by lowest low made below the technical boundary
- The more conservative option → usually offers a wider stop
    - Less likely to get spiked on a retest of the level (if there is one)
    - More likely to offer worse R:R
- Very much a ‘know your market’ scenario (and a tidbit of discretion)
    - If your market often retests the overthrown structure, this stop placement is often more reasonable
    - If thrust candle doesn’t have much range, this stop placement is often more reasonable
    - If your market usually just shits on momentum after a trap, this stop placement may not be optimal/such a wide stop may not be necessary
- Furthermost deviation stop and thrust candle stop will not always be different (as per examples)

Stop Placement II: Thrust Candle

- Definition: ***risk defined by the high/low of the candle that took price back within the technical boundary***
- Sell setup: risk defined by the high of the candle that took price back within the technical boundary
- Buy setup: risk defined by the low of the candle that took price back within the technical boundary
- The more aggressive option → offers a tighter stop but with a higher chance of being spiked
  - Especially if there isn't much thrust to the thrust candle i.e. little space between the stop and the overthrown structure
- Very much a 'know your market' scenario (and a tidbit of discretion)
  - If your market usually just shits on momentum after a trap, this stop placement may be more reasonable
- Personally: avoid thrust candle stops unless the candle is clearly impulsive

Probability Enhancers

- High time frame trend
    - Expect false breakouts in a downtrend
    - Expect false breakdowns in an uptrend
- Impulsive return after exceeding the technical boundary
    - The more impulsive a move is the greater the trap → offside positions have less time to mitigate
        - Accordingly, an overthrow setup is less likely to be valid if price floated/hung around the structure for a while (thus allowing offside positions to get out) → see examples
- Technical structure selection
    - Popular/attractive/crowded levels work best → higher participation results in greater volume of unwinding when offside
    - Use high time frames as a filter (or starting point at least)
- Tight overthrow
    - Easier to define risk where price did not greatly exceed the original technical boundary

Conclusion

- Defining risk at a technical structure can be difficult and often ends up being at least somewhat arbitrary
- Overthrow allows you to remove a lot of the arbitrariness and discretion
  - Not only presented with a way to define risk, but it is at that point also a technically-compelling setup (order flow argument)
- Look for impulsive moves in price and ask yourself who's on the wrong end of it/what preceded it*
  - Range breakout/breakdown buyers offside? Some big chart pattern? Big level that should've flipped S/R failed to do so?
- Will take some getting used to → different way of looking at charts
  - Avoiding the tendency to call a level/structure 'washed'
- This is not a setup *per se* but you can build around it
  - Entry Triggers video
  - Horizontal S/R and S/R Setup video

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