MARK MOLNAR

From Turtle Trading To Price Channel Breakouts, Trend-Following Systems Continue To Win

Donchian Breakouts

Buy strength and sell weakness with this simple yet effective breakout trading strategy.

by David Penn

There may be as many different forms of the Donchian breakout as there are moving average crossover or pattern recognition strategies. This is not without good reason. As the authors of *The Ultimate Trading Guide* note, "Traders are always excited about leading-edge technology, but inevitably fall back on the classical approaches."

Donchian breakout–oriented systems, in which trades are initiated when current prices exceed the high or low price of a given period, are chief among such classical approaches. In fact, elements of the Donchian breakout have found their way into a number of trading systems, ranging from the Turtle trading system to a number of mechanical price-range breakout approaches.

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FIGURE 1: THE SPDRS IN A 30-DAY PRICE CHANNEL. Sell signals occur when prices drop below the bottommost price channel line.

Many who have extended this breakout strategy have cautioned that there is more to trading than *n*-period breakouts. While this is absolutely true, it need not detract from the effectiveness of Donchian breakouts in terms of entering trades.

One of the more difficult aspects of trading in general and trend-following in particular is establishing when a trend is in place. Occasionally, by the time a trader identifies a trend, a consolidation or short-term reversal (in hindsight, at least) appears to cloud the picture. By waiting for prices to exceed previous highs or lows, according to those who use Donchian strategies, traders are more likely to have probability on their side.

As the Donchian breakout does not provide exit instructions, those who have used such breakouts have had to develop (or borrow) their own exit strategies, often using trailing stops. This discussion, however, will focus on the effectiveness of using Donchian strategy for entering trades.

Channels and Breakouts

One of the easiest ways to see the robustness of the Donchian breakout approach on a price chart is through the use of price channels. Similar to Bollinger Bands in appearance, price channels are the plotting of a pair of lines at a certain distance from price action.

Whereas Bollinger Bands act more as support and resistance zones, marking off two standard deviations from prices, price channels in a Donchian context are used simply to track highs and lows over a given period. Technician Richard Donchian originally used four-week (30-day) periods, but since then a number of Donchian-based traders have modified this approach to embrace both shorter and longer time frames, including weekly periods.

Using a price channel helps make breakouts all the more clear. The chart of the Standard & Poor's depositary receipts (SPDRs) in Figure 1 displays price action against a 30-day price channel. The channel marks both the moving highest high and the lowest low of the most recent 30 days. An initial sell signal comes on February 21, when prices first close below the bottommost price channel line. In this case, the SPDRs fell from 128 in late February to approximately 111 by mid-March, a loss of 13%.

After that, there is no buy signal in the SPDRs until May, when prices begin to break out of a consolidation area. Unfortunately, prices were unable to sustain the rally; after breaking above the topmost price channel line on May 16, the SPDRs retreated to the bottommost price channel by mid-June. In fact, this retreat actually produced another sell signal on June 14 with a close of 119.

The price channel in the chart of the March 2002 corn contract in Figure 2 also helps make the case for Donchian breakouts (and breakdowns). As a trend-following approach, these breakouts tend to perform less well in sideways or range-bound markets. The corn chart shows a sell signal (breakdown beneath the bottommost line in the channel) in January. Prices move against this position initially, but a subsequent sell signal in mid-March did in fact note the beginning of corn's downtrend, one that did not reach a bottom until early June, after a loss of about 16%.

After a countertrend rally in July, another sell signal in corn was issued when prices broke down beneath the bottommost price channel line in mid-September.

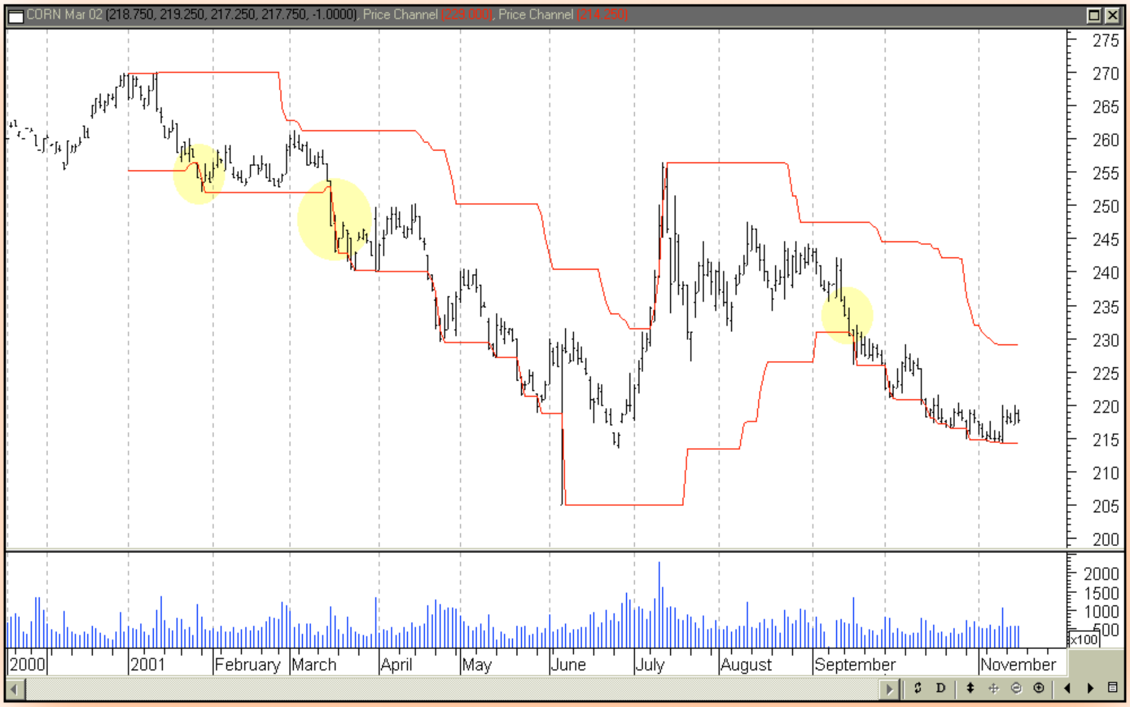

FIGURE 2: 30-DAY PRICE CHANNEL OF MARCH 2002 CORN. Here you see a short-term countertrend rally.

Other ways of stopping

The idea behind this introduction was to underscore the validity of Donchian breakout approaches to trend trading, particularly where entry is concerned. However, because the Donchian approach does not provide a ready exit strategy, at least some consideration of how to get out of a winning trade (or a losing one, for that matter) is appropriate here. Waiting for prices to move to the lower end of the price channel in the event of a long position, for example, often results in giving up much of the gains earned from buying the initial breakout.

One of the more popular ways to close a Donchian breakout–initiated trade is through the use of *trailing stops*†. Trailing stops are especially useful in closing positions for trend-following traders who avoid target prices and prefer to get the maximum out of each trend.

A trailing stop may be set in a number of ways. With a 30-day Donchian breakout approach, a trailing stop that starts at the 30-day low (or high, for a breakdown) and then contracts as time passes can help a trader keep his or her gains and avoid being *whipsawed*† (which can happen in the most steadfast of trends).

A related method calls for a trailing stop midway between the top and bottom price channel lines. The theory behind this stop-loss method is that, in a trending market, prices that retrace more than halfway across the price channel are suggestive of if not an outright reversal, then perhaps a profit-removing correction.

Another method involves using trendline breaks to determine when to take profits. This takes the decision-making out of the realm of the mechanical. But because of the constant balancing act required with trailing stops — how tight is too tight? how loose is too loose? — using trendlines can be an attractive alternative.

Conclusion

Interviewed in Jack Schwager's *Market Wizards: Interviews With Top Traders*, legendary trader Richard Dennis — whose Turtle Traders program embraced some Donchian breakout principles — pointed out that "the correct approach is to say: 'This structure means up, and this structure means up no more,' but *never* that 'This structure means up this much and no more.'" Dennis was in particular cautioning against the overuse of historical data, including historical support and resistance.

However, his comments resonate for all trend traders and are relevant to all of the best trend-following trading techniques. Trend-followers really need only two things: a trend, and a safe (and hopefully profitable) way to get out of the trend when it begins to move against the trade. With the addition of any one of a number of exit strategies — from moving averages to trailing stops to trendlines — Donchian breakouts are a great way to ride a trend.

David Penn is a Staff Writer for STOCKS & COMMODITIES.

Suggested reading

Brys, Guy, Anja Struyf, and Luc Van Hof [2001]. "Trading The Turtle System On Currencies," *Technical Analysis of* STOCKS & COMMODITIES, Volume 19: August.
Hill, John R., George Pruitt, and Lundy Hill [2000]. *The Ultimate Trading Guide*, John Wiley & Sons.
Schwager, Jack D. [1989]. *Market Wizards: Interviews With Top Traders*, Harper & Row.

†See Traders' Glossary for definition

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