

Successful Breakout Trading

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a practical guide

Successful Breakout Trading: A Practical Guide

Using real trades, this practical guide illustrates the Breakout Trading technique.

Applied with discipline, analysis, risk management and planning, Breakout Trading gives traders the winning edge.

by Sinisa Persic, CMT

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Summary

This guide focuses on practice rather than theory. Detailed analysis of real trades walk the reader through the Breakout Trading process; from preparation: scanning charts, analysis, and gauging markets; to managing the trade: setting up entries, stops, targets, and reacting to a successful, or a failed, breakout. This short manual covers the basics of this proven trading technique.

Part I: Preparation for Trading

1. Scanning

The first step is finding the right stocks to trade. It's what's called, the scanning process. A good software package is indispensable, and my choice is TeleChart from Worden Brothers, Inc www.tc2000.com. It allows a large number of scanning criteria, enabling me to quickly review hundreds of charts during a manual scan. In my daily work as a trader and technical analyst, this functionality is essential. TeleChart also lets me switch between multiple time frames of specific charts with ease. Of course, these are only few of the many benefits that TC2000.com software offers.

What parameters you scan for depends on the trading technique or type of technical analysis you're engaged in. Fifteen years of trading experience have proven to me, breakout and momentum trading is one of the best short term (1-20 days) strategies I employ. Therefore, from among the more than 5000 stocks listed in the US Market, I select several, whose charts show a high probability of a breakout in the near future. Analyzing all the US stock charts for breakout patterns, although a great way to catch every possible breakout, is highly impractical. Thus, the candidate field needs to be narrowed, using various scanning criteria, to 800 - 1200 stock charts. I avoid (filter out) stocks priced at less than \$2 because of their inherent bankruptcy risk, and exclude those priced at more than \$2000 a share. The candidate stocks need to have reasonable volume, therefore, I filter out stocks whose average volume in the last 3 months is lower than 400,000 shares. Finally, the highest impact criteria I apply is related to trend. As the majority of breakouts happen among stocks in an uptrend, I select all stocks with a price percentage change -- in the last 30 days -- of more than 0% (at least a minimum uptrend for that period).

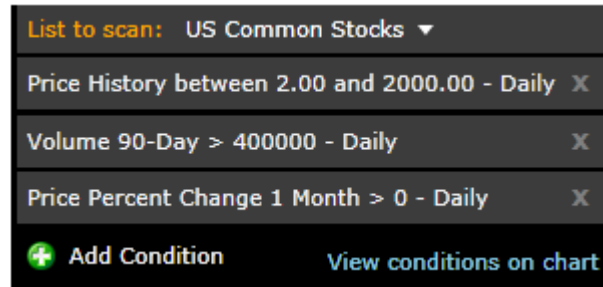


Fig 1. Scanning criteria

My initial scan provides a list of around 800-1200 stocks (less during periods of correction), I manually check these charts (using the daily time period) for any continuation chart patterns (flag, triangle, flat base, rectangle, pennant, etc.). I also look for chart patterns indicating a trend reversal, or violation of important support, or resistance, levels. Here are typical examples of chart patterns that I look for during the manual scan:

An Ascending Triangle is a bullish chart pattern. Its distinct shape, created by two trend lines, makes it easy to recognize. In an ascending triangle, one trend line is drawn horizontally at a level that has historically prevented the price from heading higher, while the second trend line connects a series of higher lows. Traders enter into long positions when the price of the asset breaks above the upper trend line (resistance).



Fig 2. Ascending Triangle Breakout

A Rectangle is a chart pattern that connotes a continuation of the trend following a period of range bound price action. The pattern is defined by two comparable highs and two comparable lows. Two parallel lines drawn at the top and bottom of the range -- one horizontal line through the highs and another through the lows -- outline the Rectangle continuation pattern. Long trades are entered as the price breaks out above the upper parallel, and short trades are entered when price breaks down below the lower trend line.



Fig 3. Rectangle Pattern Breakout

A Symmetrical Triangle pattern is defined by two converging trend lines, giving it its distinctive shape. The upper trend line connects a series of lower highs, while the lower trend line connects a series of higher lows. Both trend lines act as barriers that prevent the price from heading higher or lower, but once the price breaks through one of these trend lines, a sharp movement often follows.



Fig 4. Symmetrical Triangle Breakout

Flags and Pennants are short-term continuation patterns that mark a small consolidation before the prevailing trend resumes. These patterns are usually preceded by a sharp advance or decline with heavy volume, and they tend to occur around the mid-point of the move. The only difference between the two patterns is that a Flag resembles a parallelogram (or small Rectangle) marked by two parallel trend lines sloping against the trend, while a Pennant consists of two converging trend lines, resembling a small Symmetrical Triangle.



Fig 5. Bull Flag

The previous chart patterns are textbook perfect examples of breakouts. However, reality requires flexible interpretation of trend lines that rarely connect all the highs and lows of a pattern with precision. In any case, if you recognize the main definition (body) of a particular pattern -- or a consolidation period -- with a clear breakout point, you should add that chart to your potential, trading Watch List.

The next two charts are typical examples of such situations. The first chart (CQB) contains none of the basic chart patterns mentioned above, but there is clearly a consolidation period and visible horizontal resistance. Breaking through (above) resistance usually leads to price acceleration to the upside. In fact, time proved this probability correct.

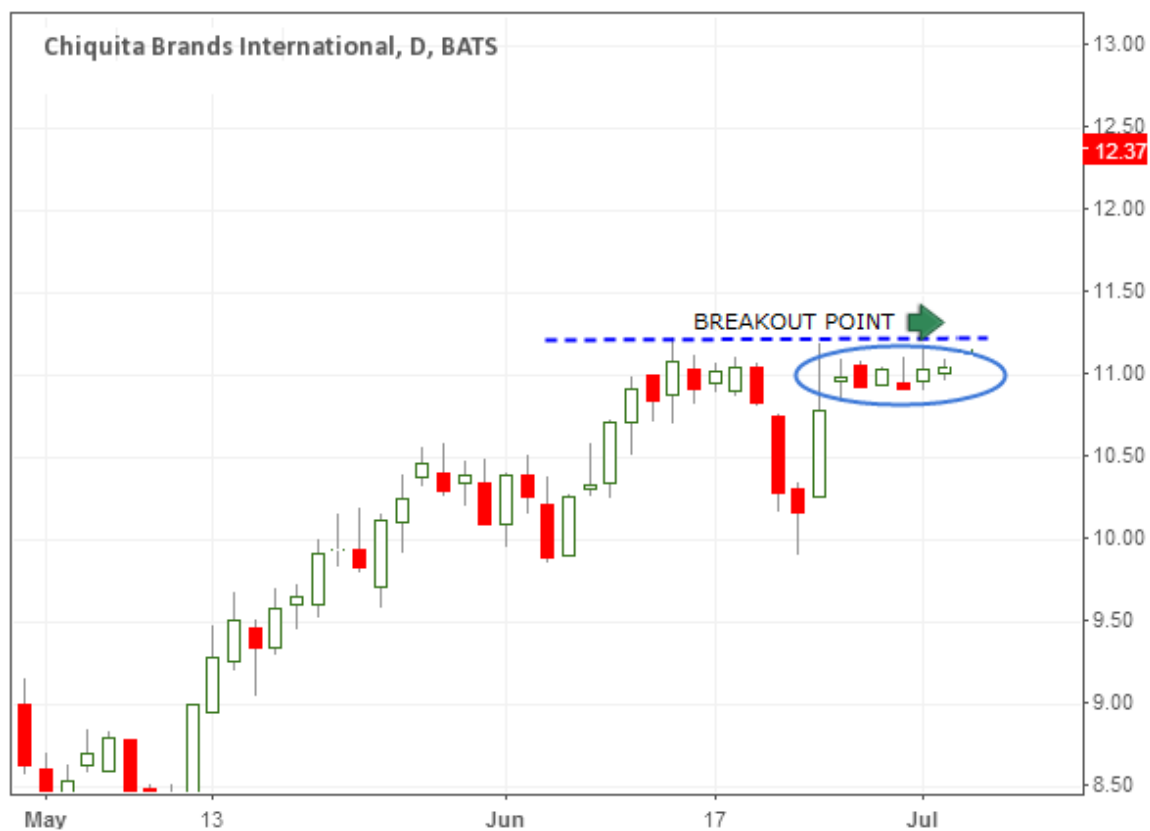


Fig 6. Breakout pattern



Fig 7. Successful Breakout

The following chart exhibits an Ascending Triangle pattern. It's also an excellent example of the perceptual flexibility that pattern recognition requires. This flexibility sets humans apart from computers -- so far. Despite penetration of the lower trend lines (1,2,3), and the absence of a third retest of horizontal resistance (4), the human eye-brain easily perceives the ascending triangle formation. This pattern formation is definitely a candidate for a trade alert, thus, it should be added to the Watch List.



Fig 8. Ascending Triangle Example

Price accelerates after horizontal resistance is broken.



Fig 9. Successful Breakout

During the manual scan, I usually select between 10 and 30 promising charts. These are the charts I expect, over the short-term, to have a high probability of breaking out. I then provide these charts to the subscribers at TraderHR.com as a Watch List for their own trading and research. Trading from these charts requires monitoring their price action during market hours. Possible breakouts are confirmed, or invalidated, throughout the trading day, therefore, I perform two scans and post the results to watch lists on TraderHR.com between 10 and 11 am Eastern Time, and then again, around 2:30 pm.

2. Chart Analysis

The process doesn't end with the Watch List. Every chart on that list is additionally analyzed on multiple, intraday, time frames (5, 15, 30, 60min). Those displaying intraday breakout patterns -- where the breakout point is at the same price level as the daily chart -- tend to strongly accelerate once that common resistance is broken. Hence, those charts become the most promising candidates for a trade. I call

them, 'Breakout Charts to Watch' (BCTW). I usually post 1-3 Breakout Charts To Watch (BCTW), per day, on TraderHR.com. These Breakout Charts To Watch include the entry, stop and target price levels, as illustrated by the following example of a BCTW.



Fig 10. Breakout Chart To Watch Example

The following two examples illustrate why only particular charts are chosen as Breakout Charts To Watch (BCTW), and why I consider these charts prime trading candidates. The first chart displays a breakout formation in the daily time frame: Following two weeks of consolidation, its price is again approaching and testing resistance at the \$61.00 level. If the resistance is exceeded -- broken -- the price of this stock is likely to accelerate upward.



Fig 11. Breakout Pattern on Daily Chart Period

Detailed intraday chart analysis (5-60 min time frames), provides a much clearer picture of the current chart formation. The following example shows an Ascending Triangle pattern, formed on a 30-min chart, with clear resistance at \$61.30. Both the daily and the 30-min chart patterns display the same breakout point. This time frame confluence increases the probability of an accelerated move once resistance is broken. Intraday chart analysis (5-60 min time frames) improves the precision of entry and stop levels, leading to a better return vs. risk ratio. In the following trade, I chose \$61.35 as the entry level (above the current resistance area) and \$59.90 as my initial stop loss (below the lower trend line: support).



Fig 12. Ascending Triangle Pattern on 30 min Chart

When a chart has met my criteria, and passed analysis on all time frames, it becomes a BCTW and Trade Alert Candidate: a feature of TraderHR.com's Live Trading Room service which additionally includes all trading instructions -- entry, exit, stop loss, and size. During the trading day, and with additional analysis, a Trade Alert Candidate may become an actual Trade Alert. Crucially, market direction must be considered: the strongest influence on a stock's performance is the overall market trend. In an upwardly trending market, the probability of a successful breakout trade is much higher. In practice, one should increase trade size, or exposure, during upward market trends and scale back when the market appears range bound, or in a period of correction. During uncertain market conditions it is prudent to focus on defensive stocks or stocks with an inverse, or no correlation to the market. Of course, staying out of the

market -- choosing not to trade at all -- during these non-trending periods, is the safest strategy of all.

The following S&P 500 diagram illustrates how you might manage your account and trading during the various, cyclical growth, consolidation and correction periods.



Fig 13. Market Analysis

Following a market analysis -- to determine its trend (growth, consolidation, correction) -- confirm that the Bollinger Bands of the Candidate Trade Alert stock's chart show it transitioning from a period of contraction to a period of expansion. Volume is also important and should be stronger than average, even increasing. A general rule about volume: A pattern breakout with increasing volume and acceleration in the direction of the trade confirms the breakout. However, it's possible that volume doesn't pick up until the initial breakout phase completes, therefore, if you have an excellent chart pattern and market trend analysis validating the breakout, it's not always necessary to wait for volume confirmation. Following the initial

breakout phase, if volume is still not increasing, consider reducing the position and tightening the stop-loss to minimize loss, should the breakout fail.

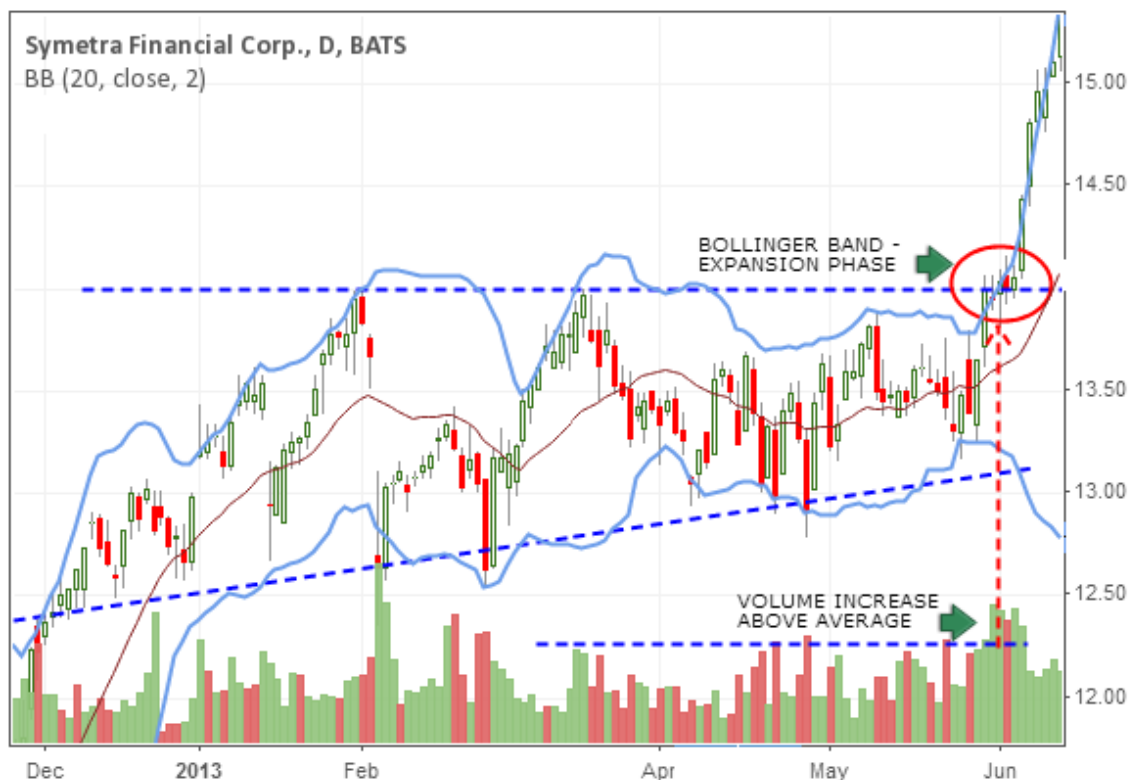


Fig 14. Breakout Confirmed with Bollinger Bands and Increased Volume

Finally, before placing an order, make sure the company isn't about to report quarterly or yearly earnings within the next couple of weeks. Holding positions during such reporting periods can dramatically increase volatility and lead to losses. It's also important to note that biotech & drug stocks can be in the process of FDA (Food and Drug Administration) approval for some of their products. Holding such a stock when, for example, the FDA does not approve a product, can lead to substantial losses. Therefore, before buying any stock, check the latest news, company events scheduled in the near future, and message boards connected with that stock. It is sound trading practice to know the basic fundamentals of the company you are trading. This information is readily available on popular financial websites such as; Yahoo Finance, Google Finance; financial news

sites such as MarketWatch, Bloomberg; and the company's own website.

Part II: Trade

1. Trade Setup

In the following example, CQB has passed all of the analysis steps required for an approved trade. The chart shows that for the last 7 days there's been a strong bullish trend with tight consolidation below resistance at 11.20.



Fig 15. Breakout Pattern on a Daily Chart

It's of vital importance that BOTH the daily, AND the intraday, time period charts display a bullish formation. The intraday chart (30min) provides greater precision and proves consolidation, approaching the resistance area (breakout point). If a breakout occurs, above resistance at 11.20, I will enter the trade. This means I will set a buy-stop, market order at 11.25. The rising, lower trend line (red) provides me with an initial, stop loss guideline. In this case, I set the initial stop loss at 10.85. This is slightly below the rising trend line in order to prevent the trade stopping out on a retest of support.



Fig 16. Breakout Pattern on a 30 min chart

A properly planned trade, not only consists of a defined entry and stop loss, but must also outline a reasonable expectation of return through planned exits. My strategy is to implement two exit points. The first being a 25%-50% reduction in the size of the trade after the initial breakout (or momentum, or 1st wave -- which many times, happens within a few hours of entry). The second planned exit closes the rest of the position (50%-75%) at the second target, or the trailing stop, depending on which is reached first.

I use a combination of Fibonacci extensions, Trend Line charting, and analysis of prior Support and Resistance levels to determine the exit points. For this trade, I used the upper trend line and Fibonacci extensions to approximate the levels at which to exit. According to the chart, the first exit is defined by the rising resistance trend line in the 11.60 area. If reached, this is where I would take partial profit. The final target level at 12.25 is the 1.00 Fibonacci extension of the move

from the 'Most recent swing low' to the 'Most recent swing high.' However, stock price action is inherently unpredictable due the massively combinatoric interaction of multiple factors, thus, it requires constant monitoring, flexibility and reassessment of the trading plan. For this reason, I highly recommend protecting all positions through the use of a trailing stop.



Fig 17. Target Projection

The final consideration before taking this -- or any -- position is Risk Management: how many shares to buy or short. Every trader has their own threshold of risk tolerance and portfolio exposure. Knowing yours is essential. There are, however, some rules of risk management that should always be followed. First, never put more than 25% of a portfolio in a single stock. Second, check market conditions before placing the trade order to ensure the environment hasn't changed since performing the chart analysis. If it has, your risk management should be adjusted accordingly. For example: if you normally invest 25% of your portfolio in a single stock when market conditions are favorable and strongly trending, you will want to

reduce your exposure to perhaps no more than 10%-15% during corrections and range bound markets. Then again, if you prefer a conservative strategy, stay in cash during these unfavorable periods. Third, know what the maximum loss is that you can tolerate, and trade only as many shares as would incur that loss (or less), should the position be closed at the initial stop loss. To calculate the number of shares to trade, so as not to exceed your maximum, single trade loss, use the following equation:

$$\text{Number of Shares} = \frac{\text{Max. Loss Per Trade}}{\text{Entry Price} - \text{Initial Stop Loss Price}}$$

Thus far, I've covered only the basics of risk management. A popular, more sophisticated approach involves optimizing the size of new trades based on past performance. Known as the Kelly Formula for Money Management, as follows:

$$\text{Kelly \%} = W - \left[\frac{(1 - W)}{R} \right]$$

W - Winning probability (divide the number of trades that returned a positive amount by your total number of trades -- positive and negative) R - Win/loss ratio (divide the average gain of the positive trades by the average loss of the negative trades) Kelly % - The percentage (a number less than one) that the equation produces, represents the size of the positions you should be taking. For example, if the Kelly percentage is 0.15, then you should take a 15% position in each of the equities in your portfolio

2. Breakout Trading Examples

Once all the Breakout Trading criteria have been met, a position may be initiated. Although a chart looks promising, the expected breakout might not occur right away, and price will not trigger trade entry for some time. In this case, it is appropriate to hold the Buy Order as long as the pattern remains valid, and price doesn't violate the trade's initial stop loss. Should the stock price reach the trade's planned

initial stop loss before the trade is triggered, the pattern is invalidated and the Buy Order should be cancelled.



Fig 18. Breakout Pattern on a 30 Min Chart -- Trade Cancellation

The situation on the chart above is hypothetical -- re-drawn in order to show when to cancel a buy order.

Trade entry is, in my opinion, the most important point of the breakout trading process. Depending on the stock price's reaction to the breakout, which triggers trade entry, the position will be reduced at the first target (partial profit taking) or closed at the stop loss. In this case, price accelerated upward from the breakout entry point, as predicted during the preparation process. In fact, the stock price spiked, and within 2 hours reached the first resistance level (defined by Fibonacci extensions during the trade planning phase), where trade size is reduced by 25-50% and partial profits are taken.



Fig 19. Partial Profit Example

Following the first wave of momentum from a breakout, and upon reaching the trade's first target, price tends to enter a period of consolidation or correction. This example illustrates a sideways consolidation. As the first target is reached, partial profits are taken, and consolidation begins, the initial stop loss is left at its initial stop level. However, once price breaks out of the new intraday consolidation period and makes a new high, the stop loss is adjusted to just below that consolidation. The trend continues as a series of breakouts and consolidations. By adjusting the stop loss to trail the trend, below its periods of consolidation, profits are protected from a reversal of the trend and invalidation of subsequent breakouts.

In the example below, I use horizontal support on the intraday charts as a guideline for stop adjustment, but it's not the only way to adjust stops. On some charts it's better to use trend lines, moving averages, ATR (Average True Range) or Parabolic SAR (Parabolic Stop And

Reverse). It depends on the nature of the breakout trade, the chart pattern and your risk tolerance, but it is vitally important to use one of these trailing stop tactics to lock in profits and prevent losses in the event of a trend reversal.



Fig 20. Stop Adjustment

After partial profit taking, consolidation, and then, stop loss adjustment, the price of this example breakout trade spiked toward the 12.00 area. It then entered a correction, reversing direction, to retest support at 11.60. Because the stop loss was set below that support, in the 11.50 zone, the trade was protected from a failure of support, yet allowed to continue through a retest and correction. When price again broke the previous high at 12.20, the trend was reinforced with a confirmation of its basic characteristics: at least two higher highs and two higher lows.

By connecting the higher lows with a trend line, I had a new guide for the placement of the trailing stop. With the continuation of the trend

confirmed by the new breakout above 12.20, I adjusted the stop from the 11.50 area to the 11.70 area. In this trade, the breakout above 12.20 was very strong. The stock price quickly reached the main (second) target in the 12.40 area, thus, I closed the position with a 10% gain.



Fig 21. Stop Adjustment, Second Target Reached

The next example uses an intraday chart to illustrate a failed breakout and the management of such a trade.

Every Breakout Trade starts the same way: candidate daily stock charts are scanned for breakout formations. In this example, an Ascending Triangle pattern was forming after months of consolidation and was approaching horizontal resistance. A break of this resistance could lead to price acceleration; the primary condition upon which to add a chart to the watch list.



Fig 22. Ascending Triangle on Daily Chart

Next was an analysis of the intraday chart. It too, showed MUR in a breakout formation (Ascending Triangle) on the 15 min chart. This meant that another condition for inclusion on the list of Breakout Charts to Watch had been met: bullish chart formations -- with the same breakout point -- in both the daily and intraday time periods. A review of the current market conditions and other technicals favorably reinforced the validity of this trade set up. I planned the trade alert by setting a Trade Entry price level, an initial Stop Loss, and price Targets.



Fig 23. Ascending Triangle on 15 Min Chart

Entry occurred at 64.90 during a move through and above horizontal resistance. I used horizontal support as a guideline for the initial stop (red line) at 63.30. By placing the stop below the lower rising trend line (blue) at the anticipated time of entry, I was giving the trade room for a correction and test of support without stopping out. I then calculated my risk, and the size of my trade, with one of the methods explained in the risk management section.



Fig 24. Trade Setup

To determine the targets, I used Fibonacci extensions and the rising, upper trend line. Using Fibonacci extensions for target determination is extremely helpful and simple. I use Fibonacci extensions in almost every trade I plan. I take the distance between the most recent swing low (number 1) and the most recent swing high (number 2) and plot the Fibonacci extensions from the retracement point of that move (number 3). This projection indicated that the first target was in the 65.75 area, while the main target, at the 1.618 ratio, was in the 67.10 area.

With the required parameters determined, I placed the buy-stop order.



Fig 25. Target Projection

Price triggered the trade entry and continued, with momentum, toward the first target area. It, however, failed to reach the first target, reversed and triggered the trailing stop on the first part of the position (based on the dashed, red trend-line). To explain the first part of this trade precisely: I regard every trade as consisting of two parts. The size of each part is usually the same, 50/50, but other percentage ratios may be used based on your personal, risk strategy. The rationale for this approach is that the price action at the time of entry or breakout is of utmost importance in determining how the rest of the trade will perform. Since my entry is set at the breakout point, once a trade is triggered, I need to see immediate acceleration toward the first target. If that is not the case, and price reaction is slow, I will close/reduce the position by selling half. In short, I refer to this strategy as 'UP or OUT': meaning I have 'zero' tolerance for downside, once I am in a position.



Fig 26. Breakout - Initial Phase

After the initial breakout (and partial profit taking at the trailing stop), the stock price descended to the newly established, horizontal support at 64.50 and consolidated just above it. As a new, higher low was established at 64.50, I adjusted my stop on the remainder of the position to right below the new horizontal support, which also happened to be just below the rising trend line, then at 64.10.

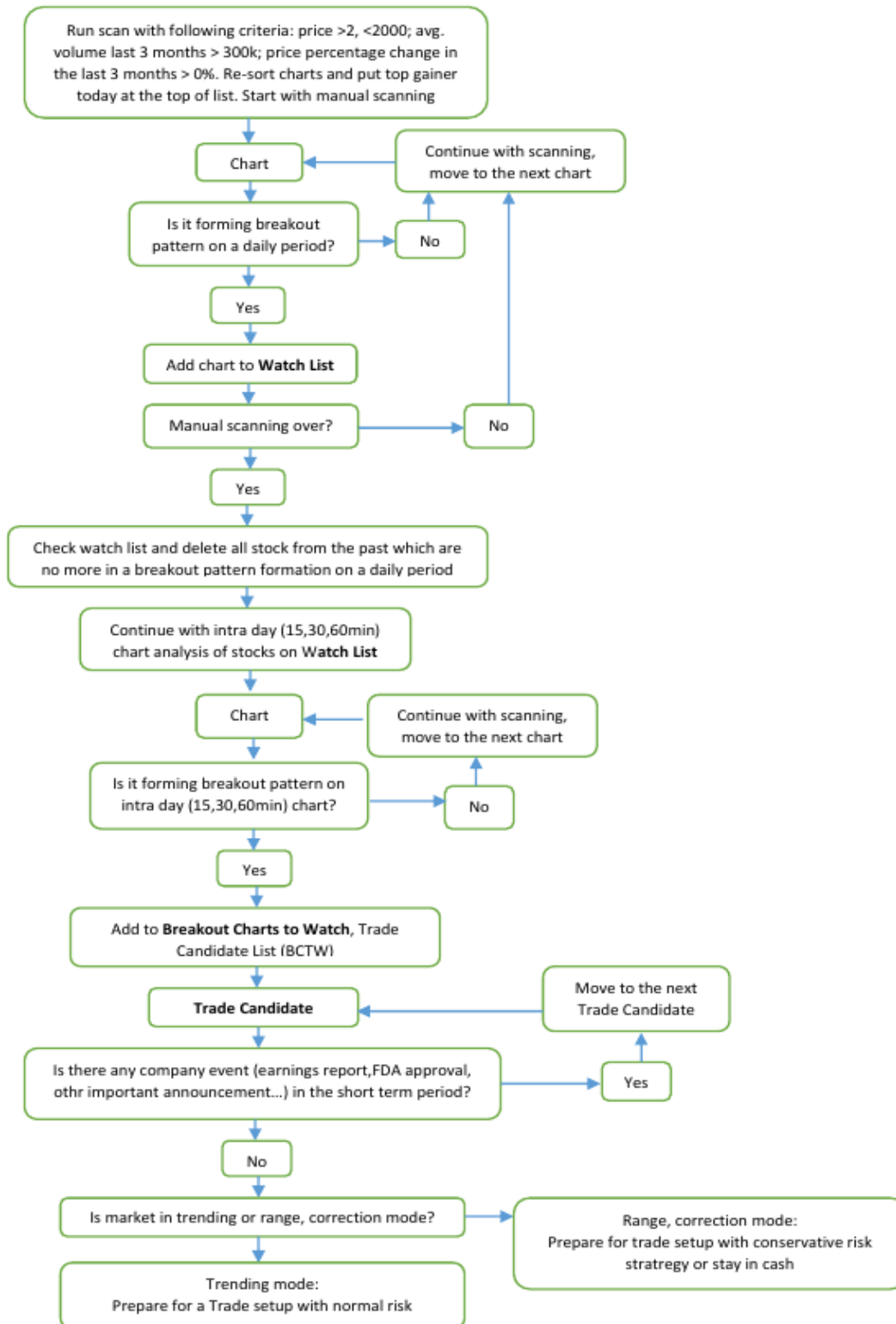
Consolidations and corrections are usual and commonly occur after strong moves, however, to consider an up-trend still valid, any new low should be progressively higher than the one before it, and new consolidation must form above previous consolidation. The same is true for new highs: each new high should be higher than the last. This example was presented as a classic, failed breakout. It also shows that with proper management of the trade, including partial profit taking after the first wave, and appropriate stop adjustment based on

trend lines and horizontal support on intraday charts, loss can be minimized.

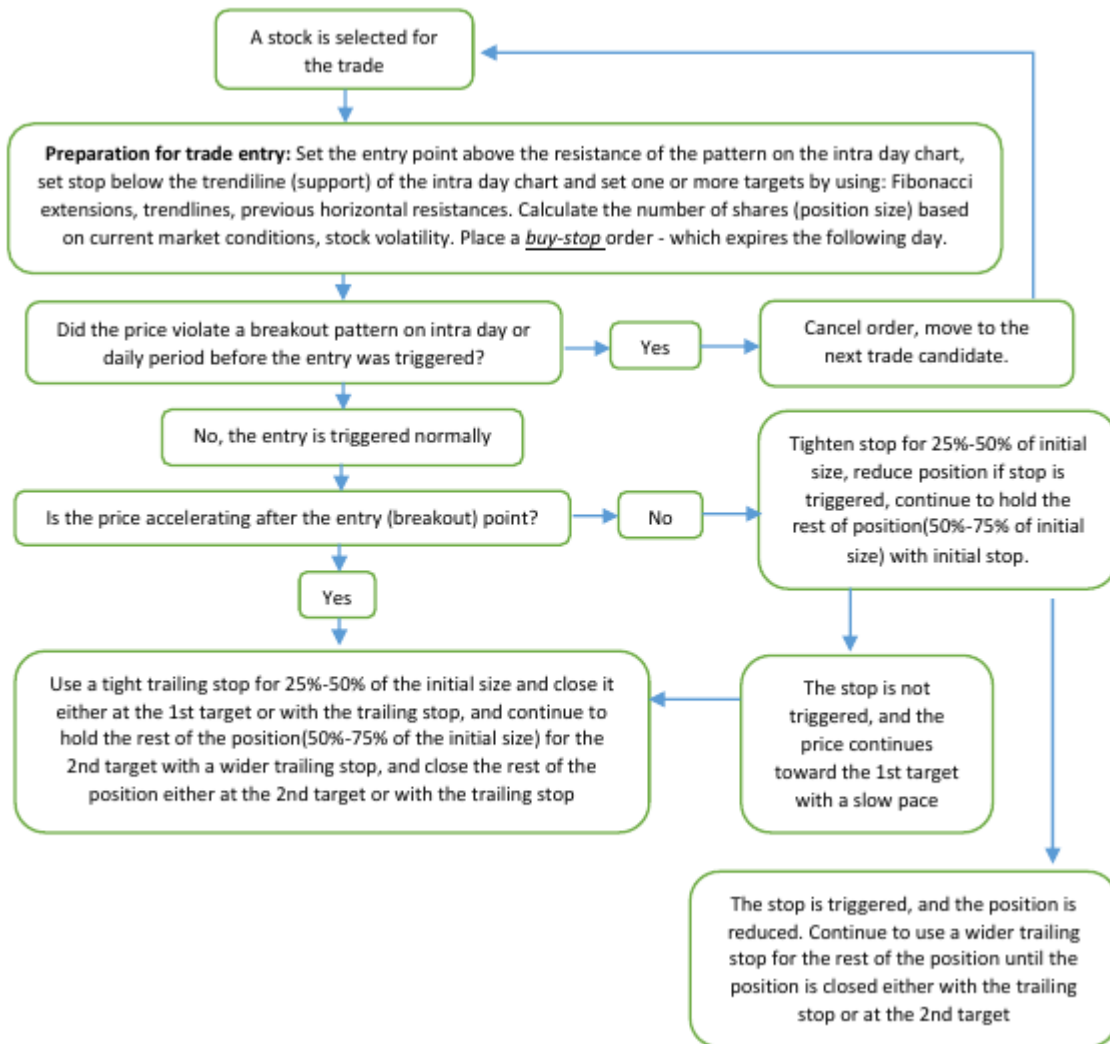


Fig 27. Breakout Failed - Exit of Position

Flow chart- Scanning and Trade Setup



Flow chart- Trade Management



About the Author



Sinisa Persic, CMT (Chartered Market Technician), is the creator and moderator of TraderHR.com. He is a member of the Market Technicians Association and a contributor to MarketWatch. Mr. Persic's strategy involves monitoring a vast array of stocks to identify candidates building strong continuation and reversal patterns.

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Sources:

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