

TRADING WITH ICHIMOKU CLOUDS

*The Essential Guide to
Ichimoku Kinko Hyo
Technical Analysis*

MANESH PATEL, CTA

Trading with Ichimoku Clouds

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Kinko Hyo Technical Analysis*

MANESH PATEL



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*I am dedicating this book to my late father
Ramanlal K. Patel—a father who encouraged me to
be the best I can and to follow my dreams.
If it were not for him, I would not be who I am today.*

A portion of the proceeds from this book will be given to various charities around the world in his name.

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Introduction

BACKGROUND

“Japanese Candles” is a phrase that is well known among the trading community. If the phrase is searched on the Internet, 3,810,000 searches are available in the Google search engine today. In comparison, if “Ichimoku” is searched, 141,000 searches appear, which is quite a difference. Steve Nison brought Japanese Candlesticks to the Western world and did a great job illustrating how it can be used to become a successful trader. He left a huge mark on the trading community, and today institutions down to the average retail trader use Japanese Candlesticks in some form or fashion in their technical analysis.

This book brings the next phase of Japanese technical analysis to the Western world, “Ichimoku Kinko Hyo.” Ichimoku Kinko Hyo is a system that has been used successfully throughout Japan for years but never has progressed forward in the Western world. If a trader combines Japanese Candles with Ichimoku Kinko Hyo, a powerful system is available to him or her. In fact, it increases the probability of trading drastically and can be evidenced by trading in a “paper” account after reading this book. Japanese Candlesticks will not be discussed further in this book and any additional information regarding this topic is available through Steve Nison’s books and training seminars.

By the time this book is published, the market will be one that has not been experienced previously; not even historical traders can predict what the future holds. There are no historical references to the current market models. We have seen the volatility index (VIX) (Figure I.1), which averaged a value of 10 to 12 for a number of years in the middle of this decade, and exceeded 50 for the first time during the collapse of the global financial markets. Why is this market different from any other historical period?

One of the biggest reasons that the market is so different is technology. With the advent of the Internet, information can be received *globally* in a matter of milliseconds. During the crash of 1929, no computers were available and television was in its early stages. The first televised live broadcast from a plane had just occurred. Two years earlier, the biggest news



FIGURE I.1 TradeStation Monthly Chart of \$VIX.X Volatility Index

worldwide was: “In 1927, the president of the American Telephone and Telegraph Company in New York talked by phone to Herbert Hoover in Washington, more than 200 miles away. The president of the telephone company was able to see clearly the face of Mr. Hoover as he talked. This proved to the world that electricity could be used to carry sight as well as sound.”

During the mid-1980s, computers were still in their early stages. It was the beginning of the personal computer era—Microsoft was introducing the operation system MS-DOS 3.2, Apple was introducing the Mac Plus, IBM was launching the first laptop computer, and so forth. Technology began to advance drastically in a short period. The size of a microchip was getting smaller and smaller and the computing power within the microchip was exponentially increasing in a short amount of time. What normally took a room full of technological resources to do was now available in the size of a desktop computer.

A perfect example of the rapid change in technology is mainframes. Back in the 1970s, IBM dominated the mainframe “space.” Mainframes were performing the computing power needed by various industry groups. It would normally take an entire room size of more than 1,000 square feet just to be able to store this technology. Not only that, the room needed the ability to store all the cabling and also required the support of a

high-powered cooling system. The expense associated with mainframes was in the magnitude of more than \$100,000. Only big corporations and universities could afford such “luxuries.” Small companies had to perform calculations by hand or they had to hire some of these larger corporations to perform the task they needed. With the introduction of personal computers in the mid-1980s, small companies and private individuals were now able to directly participate in the computer era. Prices dropped from a six-figure number to a magnitude of \$3,000 to \$5,000. My personal experience back in the 1980s was with the Apple IIE and then progressed forward with the IBM XT machines with Microsoft DOS. These were the days where there really was no graphical interface and everything was in the form of pure text.

In the 1990s, technology introduced the concept of the Internet and the World Wide Web. A drastic event in a small town in India now can be heard and seen throughout the world in a matter of seconds. Information traveled the world in microseconds compared to days/weeks/months as it did in earlier decades. In regard to the financial markets, one event in a particular market caused an instant “chain reaction” across all financial markets globally within a short amount of time. Not only can the events occur instantly but they can also affect everyone, that is, lower, middle, and upper classes worldwide. By the late 1990s, almost every individual around the world had some sort of investment in some financial market, either through an online real-time brokerage account, money market account, CD, retirement account (401(k)), and so forth. Control was now in the hands of an emotional retail customer compared to a professional trader.

In this book, you learn the key aspects of becoming a professional trader. I walk you through the complete process of trading with Ichimoku Kinko Hyo. After you read the book, various resources are available to you to make sure that your journey into the “Ichimoku world” is successful.

Types of Trading

In order to trade, two key questions always need to be addressed:

Question 1: When and what price should we enter the trade?

Question 2: When and what price should we exit a trade?

There are two analytical models—Technical Analysis and Fundamental Analysis—that help the trader get the answers to these questions. Technical analysis consists of looking at price and time action for a particular instrument. Today, online brokerage accounts along with other firms offer a retail customer hundreds of indicators for price and time analysis. The indicators are sometimes called “studies” and they are mathematical

formulas that represent price and time action in a certain way. With a certain rule set, the graphical indicator tells a trader key information on what has been happening with price over a certain time period. Examples of some indicators are Moving Averages, Average True Range (ATR), Stochastic, Pivot points, and so forth.

Hundreds of different strategies can be found with these indicators. Strategies take the various indicators and come up with a certain set of rules that the trader can follow to trade. Infinite numbers of possible strategies can be created for a trading system by a trader with the hundreds of indicators available. Furthermore, some strategies focus only on certain markets and on certain time frames. The days of trading based on a simple strategy are gone! Technical charts are now cluttered with indicators, lines, text, graphical objects, and so forth. The charts are so cluttered that it is hard for anyone new to understand a chart at “first glance.” It takes days and even months for someone to understand how to trade based on someone’s trading system.

My background is engineering and as a result, I tend to overcomplicate things as many engineers have a tendency to do. Before the days of Ichimoku Kinko Hyo, I mainly traded stocks. If someone looked at my charts before I adopted Ichimoku Kinko Hyo, he or she would be completely confused. In performing a technical analysis, I would first start by drawing Fibonacci lines and Gann lines. If this revealed a possible entry, I would then look at the Commodity Channel Indicator (CCI), the Average True Range indicator, and the stochastic indicator. If I got a “green light” from *those* indicators then I would look at the *market indexes* and see if it supported my decision in the direction I planned to take.

I never wanted to trade against the market in general and as a result, I would look at the Trading Index Indicator (TRIN) and then analyze the S&P futures with Fibonacci/Gann/CCI/ATR, and so forth. If everything “lined up” on my two-monitor screen, then I moved forward to trade based on pivots. I hope that everyone followed that because I was insane back in those days. I look back and wonder how I understood the complicated process that I created. That is a lot of work just to analyze *one* stock. You can imagine how hard it was to analyze all 5,000-plus stock instruments. One person stated it perfectly to me when they saw my screens: “death by indicators.”

Unlike technical analysis, which is graphical, the second analytical model—fundamental analysis—is based on numbers. Let us first look at fundamental analysis for stocks and how it is used. In fundamental valuation for stocks, you are looking to buy a stock based on that company’s being undervalued. In order to determine if a company is being undervalued, a “fair value” for a company needs to be determined. Some traders may use a Profit/Earnings (P/E) ratio to determine whether to purchase a

stock. For example, if a P/E ratio of 10 is used, then any stock at a P/E of 10 or less could be purchased.

One of the key things I look at is the 10 P/E ratio level on a chart. If you see a P/E ratio of 10, normally you see technical support in that particular stock. Other variations that may be used are stocks at a P/E level of 10 or less as well as Cash to Short Term (ST) Liability's level of 50 percent. This would indicate the stock is trading at a low earnings multiple. The stock is well funded in terms of its debt exposure. All of this obviously has nothing to do with technicals or charting—it's financial company analysis. But when overlaying these stocks onto a chart you may be able to apply support levels to this fundamental analysis.

Today, if you listen to the news, you will see that many companies provide many revisions to their numbers and also many companies are “cooking the books.” They manipulate numbers before earnings announcements just to drive the stock price higher. Based on these manipulated values, fundamentalists will buy/sell the stock. If the truth comes out, their investment will be destroyed completely. In the last couple of years, many companies have been getting in trouble based on “accounting practices.” How can you trust the results if this is happening more and more often? Let us say that a company is not manipulating the numbers and they announce a good quarter, why does a stock go down when they beat estimates and have good fundamental values? Why will some instruments move more than 20 percent faster than their earnings percentage growth? There is no direct answer to these questions. Everything depends on speculation, which is not predictable. Here is an article in *USA Today* on June 27, 2002, on a company called WorldCom:

WorldCom's accounting game is stunning investors who thought the loophole the telecom firm used was sewn shut years ago.

Showing that accounting gimmicks may fade but never really go away, WorldCom acknowledged it improperly “capitalized” costs. This shenanigan was believed to be one that is quickly detected by analysts and, if not, used to fudge books by much smaller amounts.

“This had been a huge problem at one time, but it has receded over the years,” says Robert Willens of Lehman Bros. “How was this overlooked by people who are supposed to be looking at it?” he asks.

WorldCom used the gimmick to a level never before seen. The company showed a \$1.4 billion profit in 2001, rather than a loss, by using what’s essentially the oldest trick in the book.

Rather than subtracting certain costs—which analysts think were for maintaining telecom systems—from profit, it called them long-term investments. Doing this allowed WorldCom to inflate

earnings because the costs of long-term investments are subtracted from earnings over time, rather than all at once up front.

WorldCom wouldn't say which costs were incorrectly recorded

Things to keep in mind about improper capitalization:

High-profile companies have pulled it off before. It's an easy way for high-growth companies to delay recording costs, says Howard Schilit, president of the Center for Financial Research & Analysis.

For instance, America Online paid a \$3.5 million fine to the Securities and Exchange Commission in 2000 to settle charges it capitalized the costs of mailing out thousands of trial diskettes in the mid-'90s.

The SEC found that by not charging the expense right away, AOL reported a profit instead of a loss for three years. AOL says it stopped capitalizing the costs in October 1996 because it changed its business model. "This was completely different, as AOL's accounting was always fully disclosed and AOL did not admit any wrongdoing in its settlement agreement," says spokeswoman Ann Brackbill.

Any company in any industry can use the tactic.

We have discussed fundamental analysis for stocks but are the currencies the same? How do you now apply fundamental analysis to trading currencies? In order to answer this question, central bank policies need to be discussed. First, there is hawkish (which is a bias toward raising interest rates). A bank can do this to stop inflation, to reduce money supply, and so forth. Normally if the future of a currency has higher interest rates, then the value of that currency should increase. Next, there is a central bank policy that is dovish (which is bias toward lowering interest rates). This policy is used to increase money supply, help stimulate an economy, and so forth. If you can find a currency pair with one country being dovish and another being hawkish then you have a great currency trade from a fundamental viewpoint. For example, in the past few years, the Japanese yen (Japan had a Zero Interest Rate Policy) versus almost any currency. If you have ever heard of the famous concept "carry trade," it is dealing with the Japanese yen and other currency pairs. Since the financial market meltdown, the United States has had a policy of keeping rates under 1 percent for an extended period of time. As a result, the U.S. dollar is a carry trade with the Japanese yen and has subsequently led to a decline in the U.S. dollar.

So far, fundamental analysis for stocks and currencies has been discussed and it is apparent that you have to know a lot of information in order to trade stocks and currencies with this approach. How do the other instruments such as commodity futures (Corn, Wheat, Soybeans, Feeder Cattle, and so forth) fare with fundamental analysis? If you are trading all

these instruments, you have to have a “global” view of everything that is going on in the world in order to trade. Some traders have taken the time to learn, especially with the Internet; however, for many people that is virtually impossible.

The main goal of this book is to *simplify* trading. All the fundamental aspects of each instrument and market will be built into price. Therefore, we are only going to rely on price action on the charts to determine when to trade and when not to trade. This is the assumption behind Ichimoku Kinko Hyo, a technical system. If you are a fundamental trader, my suggestion would be to combine the technical and fundamental analysis together as part of your trading system. Remember, *your* trading system has to be something you are comfortable with and fits your “personality.” Anything short of that will be *failure*.

Now, we are going to proceed forward and start to create the foundation “blocks” for you to become a professional trader using the Ichimoku Kinko Hyo system.

COMPONENTS OF A TRADING SYSTEM

Trading and investing are very simple processes and we human beings try to make it into something much more complex. Unfortunately, we have a lot of biases that enter into trading decisions.

I believe people get exactly what they want out of the markets and most people are afraid of success or failure. As a result, they tend to resist change and continue to follow their natural biases and lose in the markets. When you get rid of the fear, you tend to get rid of the biases.

As for risk, most people don’t understand it, including a lot of professionals, and what’s really interesting is that once you understand risk and portfolio management, you can design a trading system with almost any level of performance.

—Van K. Tharp

Background

People can learn a lot about life by observing nature’s creatures, observations that can benefit every aspect of someone’s life. Let us examine a cougar and how it hunts for prey. The cougar is one of nature’s fiercest creatures. When hunting for prey, a cougar is strategic. If a cougar finds a herd of deer, it will wait patiently observing the entire herd looking for the weakness within the herd. The reason for this is that the cougar can only

run at top speed for short distances. Therefore, it is imperative to get as close to its prey as possible before making a killing strike. Otherwise, the opportunity will be lost and it may be some time before the next one appears. The more days that the cougar goes without food, the slower it will be able to run, thus making it harder and harder to attack its prey.

So why are we talking about cougars?

Playing the market is very much like the cougar's hunt for prey. Whether you are trading the Forex market, the Futures market, the Options market, the Equities market, and so forth, you must have a *plan* before entering each trade. If you do not, it will be harder and harder to find opportunities because each lost opportunity will take a toll mentally, physically, and psychologically on your well-being.

Therefore, you must observe the instrument greatly before executing a trade. In another words, you must become an *analyst* before a trader. If you are a trader before an analyst then you will be "rolling dice" at each opportunity. Just like the cougar observes its prey for weaknesses before becoming a hunter, you must analyze before trading, otherwise success will get further and further away.

An analyst observes the instrument *patiently* until an opportunity is seen. Once an opportunity is present, a plan is executed. The plan consists of entry criteria, money management, and so forth. Figure I.2 is an example of a good trading plan. A true trader will not play a "probability game" but instead wait for the market to "show" him or her the opportunity through patience and discipline.

Someone once told me "Trading is neither logical nor predictable." After years of trading, I can honestly say that statement is completely true. It

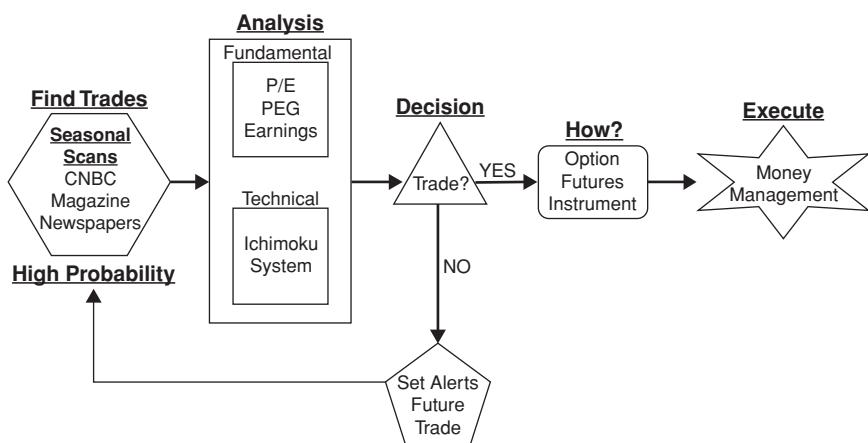


FIGURE I.2 Trading Plan Example

is a probability game. You have to have a system to help increase your probability of success or you are just gambling. By rolling a dice, a person has a probability of 50 percent on the desired outcome. Therefore, one of our goals is to trade with a higher probability of success than 50 percent. How do you do that? This can be achieved by creating a trading system that maximizes profits when you are right and minimizes losses when you are wrong (i.e., play trends instead of consolidation patterns). A trend is when price goes in a certain direction for a long period of time whereas a consolidation pattern is where price goes “back and forth” among a range of prices.

Trading Plan My mentor always stated the following: “A System without a proper mind set leads to ruin; however, the proper mind set perfectly aligned with the right mind set leads to Success.”

When evaluating trading systems and plans, we always ask the following two questions:

1. Does the system/plan cover the mind set required to trade the system?
2. Does the system/plan cover the personality required to trade the system?

Why do we ask these questions? There are many different trading plans out there. Each plan requires a particular mind set and personality from the trader using the system. Does your plan match your personality and mindset? If not then you are bound to fail. *Take the time to find what works for you!* If the trading plan we create in this book is not for you then change it so you are comfortable with it. Do not use it if you are not comfortable with it.

The first component of the trading system is the trading plan. A trading plan is where you take a certain strategy and execute it with a certain set of rules. It takes all the emotions and decision-making process completely out so someone just has to follow the trading plan and play the odds. The majority of retail traders today do not have a trading plan and are “blindly” trading. Without a plan, they are gambling instead of system trading. All they know is that they want to make money. Therefore, they go through a trial and error scenario to find a strategy that works for them. If by chance, the strategy starts to fail, they drop that strategy and seek another one. They switch strategies as much as the “mood” changes in the market. This is a dangerous strategy because if volatility is high then the market is swinging up and down drastically. As a result, there will be no consistency in trading. Without consistency, traders become less patient and the less patient a person is, the higher the probability that a mistake will be made (i.e., higher losses). This is a vicious cycle that many cannot escape!

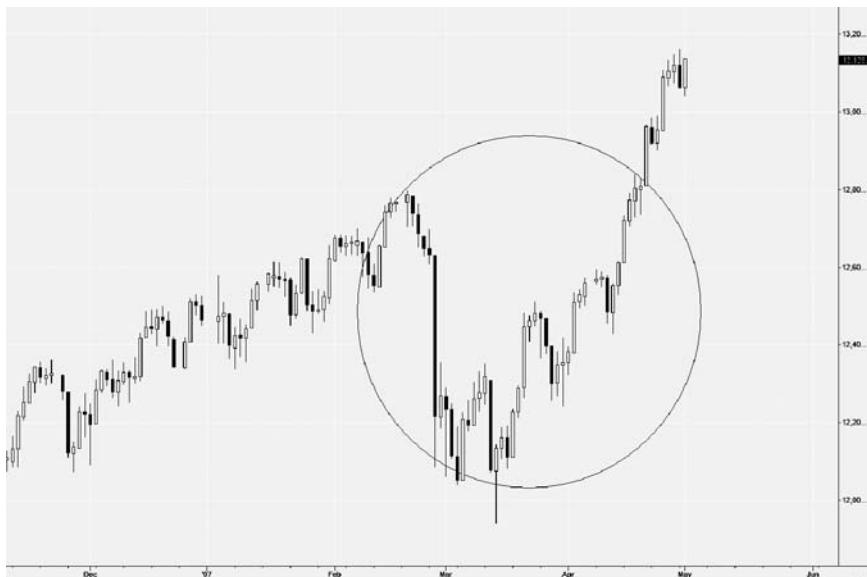


FIGURE I.3 TradeStation Daily Chart, Daily Chart of \$INDU February 27, 2007

A perfect example of this is shown in Figure I.3. It is a chart of the Dow Jones Industrial Average on May 1, 2007. On this date, the market went down drastically and there was a massive sell-off as people panicked. A few months later on April 18, 2007, the market had completely retraced 100 percent back to the original price before the big drop. In fact, the market continued to proceed higher. How many people do you think had a trading plan on February 27, 2007? How many people had “built-in” stops?

If you examine the price action before this major drop, you will see that the markets have been going higher and higher for the last couple of years. Before February 2007, the market had been in a major bull run. The price action set a mode of “quick easy cash” mentality. People could buy and walk away and expect a 10 percent average yearly profit, which was three times more than a money market savings account. Many people thought it was a “sure bet” that they started to use margin to hold positions for that quick percentage return. They did this in their regular brokerage accounts along with their retirement accounts. When the market decided to correct itself, a couple of down days caused major panic across the globe. It happened in the stock market, currency market, bond market, commodity market, and so forth. The big daily down bar is the panic that took place. The people who had a trading plan most likely were out before that major down day occurred. If you were trading with Ichimoku, you would have



FIGURE I.4 TradeStation Daily Ichimoku Chart, Chart of \$INDU Feb 28, 2007

been out of the market either one or two days before the major down day (Figure I.4).

A trading plan should consist of the following four components:

1. What instruments will be traded and when?
 - a. Instrument examples: Stock, Exchange-Traded Funds, Option, Future, and so forth.
 - b. Time frame: Tick, 1 minute, 3 minutes, 120 minutes, daily, weekly
2. Entry Rules:
 - a. Fundamental: PEG, PE, Cash flow, and so forth
 - b. Technical Analysis: Ichimoku, Moving Average, Average True Range, Fibonacci, Gann Theory, Pivots, Volume Spread analysis, and so forth
3. Money Management:
 - a. Stop: If you are wrong, where will you get out of the trade? Believe it or not, there are many traders who do not use a stop at all. They are fearful that the brokers/market makers will see their stop and run the price to hit all the stops. That is true in some cases especially if you are trading lower time frames. However, what will happen to your account if a news announcement comes and moves price drastically in a matter of milliseconds? With the use of an automated

trading system with the latest technology, millions of trades can now be executed in less than one second! Do you want to be on the other side of the trade?

Notice, I have used the word “stop” compared to “stop loss.” In my mentoring, the biggest obstacle for someone to overcome is the psychology of the word “loss” in “stop loss.” The word “loss” has a negative meaning that people fear and try to avoid. When it does occur, the person’s state of mind is altered to a point where logical thinking no longer occurs and “panic” sets in. Many people believe they do not panic when they have a loss but there are many forms of panic.

Here is a great analogy to prove the point:

In elementary school, there are two boys, the first boy’s name is Ben and the second boy’s name is Frank. Frank has a perfect attendance and is proud of his accomplishment and strives every day to make sure he maintains that status. One day, Frank was walking to school as he *normally* does each day. As he was walking, another boy named Ben approaches Frank. Ben hits Frank in the stomach for no apparent reason and then walks away. Frank does not understand why Ben did that so he does not take any action. The second day Frank walks to school and runs into Ben again. Again, Ben hits Frank in the stomach and then walks away. The third day comes and Frank, who is afraid of getting hit, decides to take another route to school in order to avoid Ben. Frank avoids Ben but he arrives to school late. The route he had to take was a route that took longer than he expected. His perfect attendance was ruined in one day due to Ben!

So what is the moral? Frank got hit once but kept on following his plan to go to school as he normally does. When the second time occurred, he was cautious but not prepared because he did not think it would happen again but it did. The third time, he reacted but he lost his perfect attendance. He was so worried about Ben he forgot about this perfect attendance, which was important to him.

When trading, if you view the word “stop” as a loss, it is a negative state of mind. If it occurs once, twice, three times, and so on, sooner or later it will alter your state of mind to a point where you will start to react to it instead of following your “game plan.” If you get stopped out of a trade that means *you were wrong*. Remember, the goal is to have a trading strategy that minimizes losses when you are wrong and maximizes profits when you are right. Notice I said minimize not *none*? Using the word “none” is not real, it is a dream world.

- b.** Profit target: Some strategies use a profit target and some don't. It is a not a *must* compared to a Stop.
 - c.** Position sizing: As the trend develops, you have an option of adding or removing positions. One strategy is where you enter the initial position with a low contract/share size. This is done to lower risk and to "test the field." If the trend develops then you add more and more positions on pullbacks. The second strategy is the reverse of the first one and you start with a large number of contracts/shares. As the trend develops, you remove positions at major support/resistance values. Each position sizing strategy has its pro/cons. You can research both types further; however, remember, you *must* select a plan that fits your personality. If you do not like risk at all then *do not* do any position sizing or any scaling in (adding) as the trend develops.
 - d.** Time Entry/Exit: Some strategies focus around time. They typically do this because volume is high or low during the trading time of interest.
 - e.** Money Management
 - i.** Risk per Trade: These parameters define the most risk that a trader is willing to take per trade. If the trade is long term, the risk per trade will be higher compared to someone who is trading on a short-term time frame. For example, most people who trade daily charts for currencies have a max risk of 200 pips per trade. They are willing to accept this value because they are expecting to be in a trade for one month to four months averaging around 400-plus pip profit. They are expecting a 2:1 profit/risk ratio on the trade. So why does this matter? The reason is that we are trading a *system* and not gambling. Everything is defined in a system so you are playing the "numbers." If you have a loss on two trades and win on another trade, you know that at least you will break even because the one win provided 400 pips in profit and the two losses totaled 400 pips. Together, it equals zero. Therefore, your worst-case scenario is one winning trade takes care of two losses.
 - ii.** Risk per Month: The risk per month should be based on the percentage of capital you have to invest. You want to make sure that you do not lose all your money in one month and end up without any cash to trade another month. Remember, you have to treat this like a business. There *will be* some negative months due to the market consolidating. During those times, your system is supposed to minimize the losses. During trend months, your system is supposed to maximize profits. Risk per month can also be called "drawn down."

- iii. Risk/Reward Ratio: The risk/reward ratio is an important calculation. It is key because we are trading a trend system. The goal of a trend system is to maximize profits when you are right and minimize losses when you are wrong. In order to achieve this, the risk/reward ratio for your system has to be less than one. Notice, I said *your system*. You may have some trades that have a Risk/Reward ratio greater than one, but overall, the backtest results should show your system has a risk/reward ratio less than one. In theory, if you can optimize your system to a point where all trades have a risk/reward of less than one, then you have a great system. This can only happen with time as you learn more about the optimization part of backtesting.
- 4. Trade Post Analysis: Probability Factor, Risk/Reward Analysis, Loss Analysis. In a later chapter, we illustrate how to “backtest” a system. Once the system has been backtested, you can get a lot of information from the backtest results. The results should show you the probability of winning compared to losing, average Risk/Reward per trade, and so forth. Information that should be used to determine whether the system needs to be “tweaked” or optimized. For example, if you are looking for a 12 percent return a year then your backtest results should give an average of 12.0 percent per year. If it does not then the system needs to be altered in order to achieve your long-term goals. Once the system backtest results meet the entire trader’s requirements, the system is traded in a live environment with actual cash. Now, the results need to be recorded for the live account because what has happened in the past does not necessarily mean it will occur in the future. Therefore, post analysis of the trades has to be maintained to verify that the system will produce the long-term goals of your business.

Remember, a trading plan is like a business plan to a business, it is a *must* and the key for a business to be successful.

In this book, we learn the Ichimoku Kinko Hyo trading system. A trading plan is created step by step around one Ichimoku Kinko Hyo strategy.

Technical Systems The second component for our trading system is going to be the technical analysis component. So what is a technical system? Is it Fibonacci? Is it Gann boxes? Is it Pivot Points? Fibonacci, Gann boxes, Pivot Points, and so forth, are some forms of support and resistance values. In fact, every technical system is some form of support and resistance.

So what is support and resistance? Support is when a user is short a position in the market (betting on the instrument going down) and price