SYSTEMATIC APPROACH TO CANDLESTICK PATTERNS

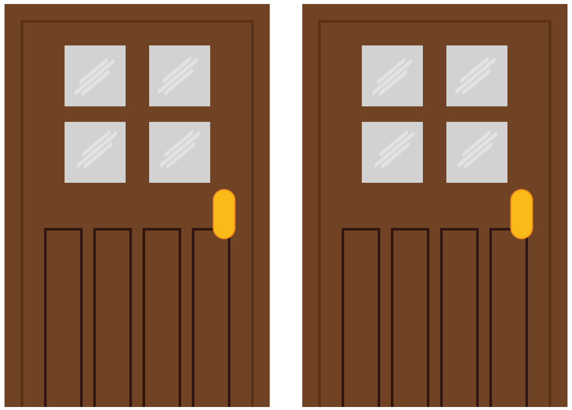
It is a common occurrence for those starting with technical analysis and trading to get extremely excited after making a good profit and extremely dejected after making a loss, even if a small one. However, according to the workings of technical analysis, we are relying on history to repeat itself when certain formations and patterns are being created. At times, the patterns do repeat themselves and at other times, the patterns simply do not repeat and we end up with a loss.

It is impossible to be invested in technical analysis and trading, without incurring losses. If someone only had profits for each time they traded, the world's richest person would have been a technical analyst. We will have profitable as well as loss-making trades. One large profit or loss does not necessarily mean anything; it can be pure luck too at times. So, instead of focusing on individual trades, we will focus on a systematic approach to trading. We will focus on a lot of factors and determine the progress of our system, i.e. if we make a profit or a loss on a systematic basis (over a length of time instead of individual trades). The trading system is a set of strategies with defined entry and exit circumstances and risk management practices in place that finds it very difficult to make sustainable profits in the market. There is no way to backtest their assumptions.

TIME OF EACH CANDLE

The very first thing that we will do is, determine the period that will be reflected in each candlestick. We saw that each candlestick can depict a variable time frame – ranging from a few minutes to even a month.

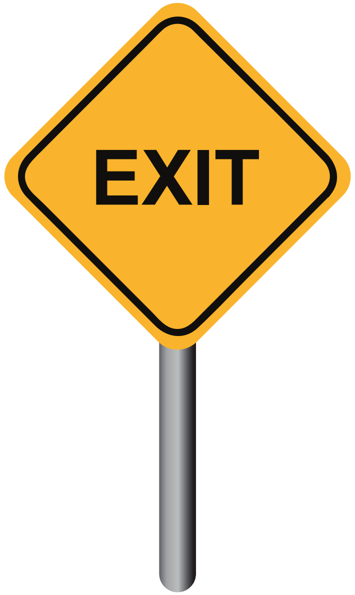
We will match the time period in each candle with the average trade period we are looking at. If we are looking at intraday trading (buying and selling within the same day), we will mostly deal with candles with a time period of 5-15 minutes. For a few days, it is 1-day candles. For holding 1-2 months, we can use daily or weekly candles. Monthly candles are used when the time frame is even longer – more than 3 months.



ENTRY STRATEGY

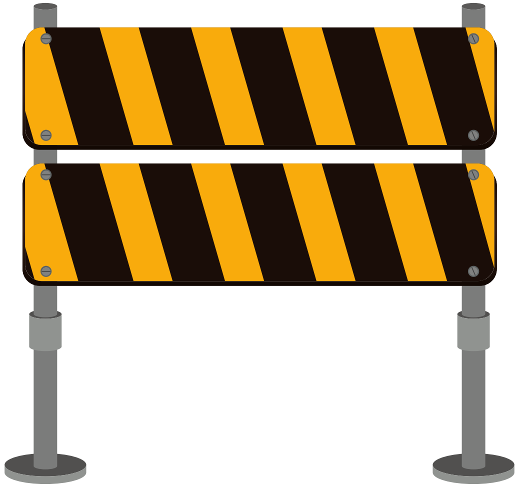
The next thing that we will determine for every strategy is its entry point. We have to identify the circumstances under which we would want to enter the trade if we decide to opt for the same. The fewer decisions to make, the better it is. For instance, let's say we are to make an entrance if there is an engulfing bear if the price next day opens lower than the engulfing bear candle's close. We will try to be as specific as possible and with time, we will fine-tune our entry strategy to make our trades even more efficient.

EXIT STRATEGY



Determining an exit strategy means examining the circumstances under which we will exit our trade and it can either be a profit or a loss. We will never enter a trade where we do not have an exit strategy worked out.

A common mistake for beginners is to figure out an entry strategy, but leave the exit strategy on gut feeling or circumstances. This makes holding a profitable trade extremely difficult. So, we will always have a pre-defined exit strategy. For instance, we may enter based on candlestick patterns and then exit based on moving averages action. We will fixate on our exit strategy and follow it through, no matter profit or loss. This will reduce the impact of emotions to a great extent in our system. We need to know that emotions are the enemy of profitability in a trading system.

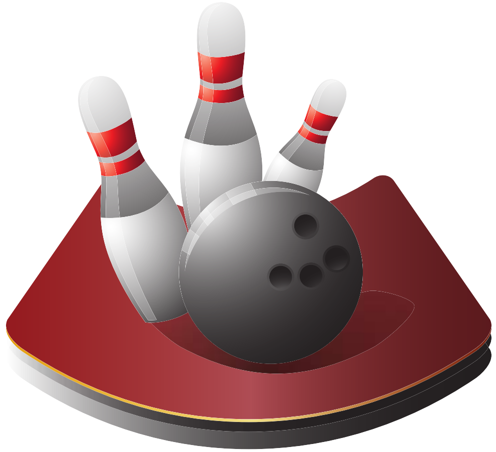


STOP LOSSES

Stop Loss refers to the limit to which we are willing to take maximum losses. Let us understand this better with examples. When we buy a stock at Rs. 100 and fix a stop loss at Rs. 95, we are limiting the losses that we can incur to Rs. 5. In this case, if the stock prices fall to Rs. 95 or lower, it will automatically be sold off irrespective of what our exit strategy says.

Similarly, when we short a stock at Rs. 100, and have a stop loss at Rs. 105, this means if the price goes above Rs.105, our position will be squared off (settled) and our maximum losses will be limited to Rs. 5.0

HIT RATIO



Hit ratio is the number of correct or profitable trades that we enter out of the total number of attempts in a fixed time frame. Let us say, based on a strategy, we entered 34 trades in the last 12 months, and of these, we made a profit 14 times and a loss 20 times. So the hit ratio is 41% (14/34× 100).

Now is this good or bad? It may look bad, but this is when our system-based thinking comes into the picture. We will combine the average profits of profitable trades with average losses of loss-making trades. This will tell us if our system is profitable or not.

PROFIT WHEN RIGHT

The next element that we need to examine is the average profit we have made out of the trades that we have entered. This indicates the average profit we have made. Let us assume, 14 profitable trades were made out of 34. The amount has to be calculated after deducting for brokerage and trading costs. Let us say, we made an average of Rs. 15,000 per profitable trade in the past 12 months.

LOSSES WHEN WRONG

In this case, the system has incurred 20 loss-making trades. Let us say, on average they lost Rs. 2,000 per trade. In this case, it is an excellent system because the system makes Rs. 15,000 when profitable and loses Rs. 2,000 when wrong. It is right 14/34 = 41% of the time. This looks like an excellent system.

However, if the average loss was also Rs. 15,000 too, we could say that this is a horrible system because, over a longer period, the system will lose money. So, combining the hit ratio with the amount we make and lose in case of profitable and loss-making trades, will create a system that is backed by data. We will learn more about these going ahead in much greater detail.

TIME OF ENTRY

Another major decision to be made when dealing with candlesticks is to fixate on a time for entering the trade based on the candlestick formation. So, we can either enter a trade at open of a new candlestick or close of the previous one. It is very difficult to trade in between a current candlestick as we are unaware of the shape it can take.

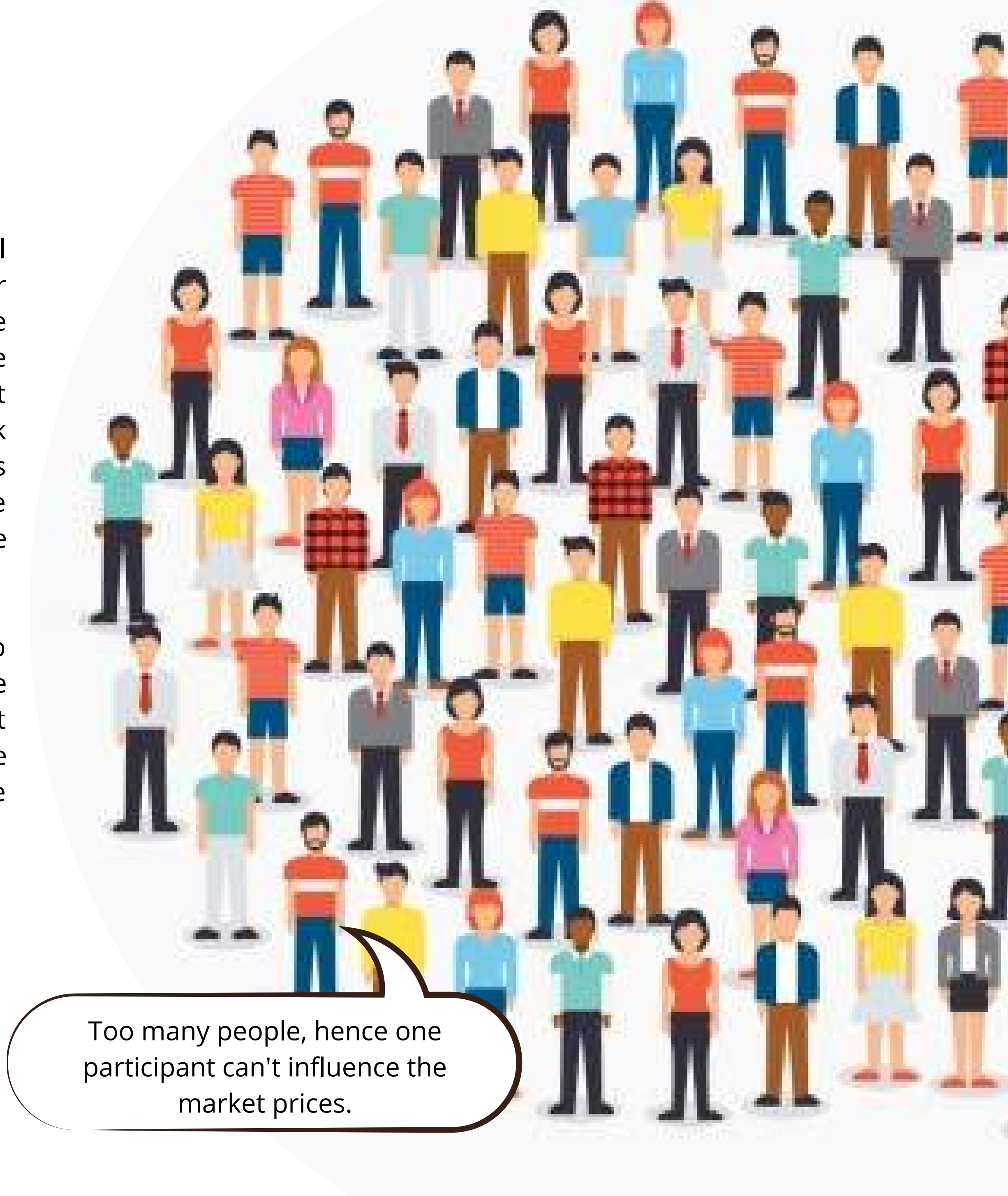
While using a daily weekly candlestick pattern, we would suggest a trade on close i.e. just before the market closes so that we have entire data based on which we are making a decision. In case we enter the trade the next day at the opening price, we are missing out on any gaps that might be present between candles, but we are taking less overnight risks.

Also, we will not indulge in any new trade through the candle duration as it could make false moves. This means every Doji looks like a trend continuation and a reversal at some point of the day before it is converted to a Doji. Every engulfing bear looks like a gap up on open. As a result, to avoid such false moves, we will only enter and exit at the end of the candlestick duration or beginning of it. However, the final choices for the trader to make.

SUITABILITY

Candlestick pattern-based trading is not suitable for all securities. We are trying to understand the balance of power between bears and bulls in the market and recognizing the one with more control at the moment. This only makes sense when no single individual or group can influence the asset price on their own. As a result, we should apply candlestick patterns only on indices, large-cap companies, commodities and currency exchange.No single person can influence these asset prices and as result, we get a reliable picture of balance between bulls and bears and their control over the market.

On the contrary, in small-cap companies and few mid-cap companies, a significant investor or promoter can affect the prices and as a result, we do not understand the correct balance between bulls and bears. Therefore, we will not use candlestick patterns on smaller companies where one individual can influence the prices.



PRACTICE FOR CANDLESTICK PATTERNS

More than our knowledge on the said topic, what is of greater significance is our application of the same. For anyone who is not well-versed with candlestick patterns, it will take time to get a hang of the same and meanwhile, they will have made pretty expensive mistakes in the market.

Hence, we will practice considerably on the historical data to understand the working of candlesticks their patterns. We expect a learner to spend 2 hours reading about candlestick patterns in the book, but then at least 20 hours should be spent on applying the same to the past data. That is where one gains confidence from and corrects the areas of mistake. So, each one of us will spend an enormous amount of time in following the practice steps below.

READING - 2 HOURS

PRACTICE - 20 HOURS

1

1. Open a chart for Nifty and use the go-to date option and go to 01 January 2000 on Tradingview.

2

2. Zoom in on the chart with 20-25 candles on the screen. We will use daily candlesticks, to begin with. We can experiment with other timeframes later.

3

3. Now, we will drop the mouse and use the arrow keys. Every time, we press the 'Right' key, we move one day forward and one new candlestick is added to the series.

4

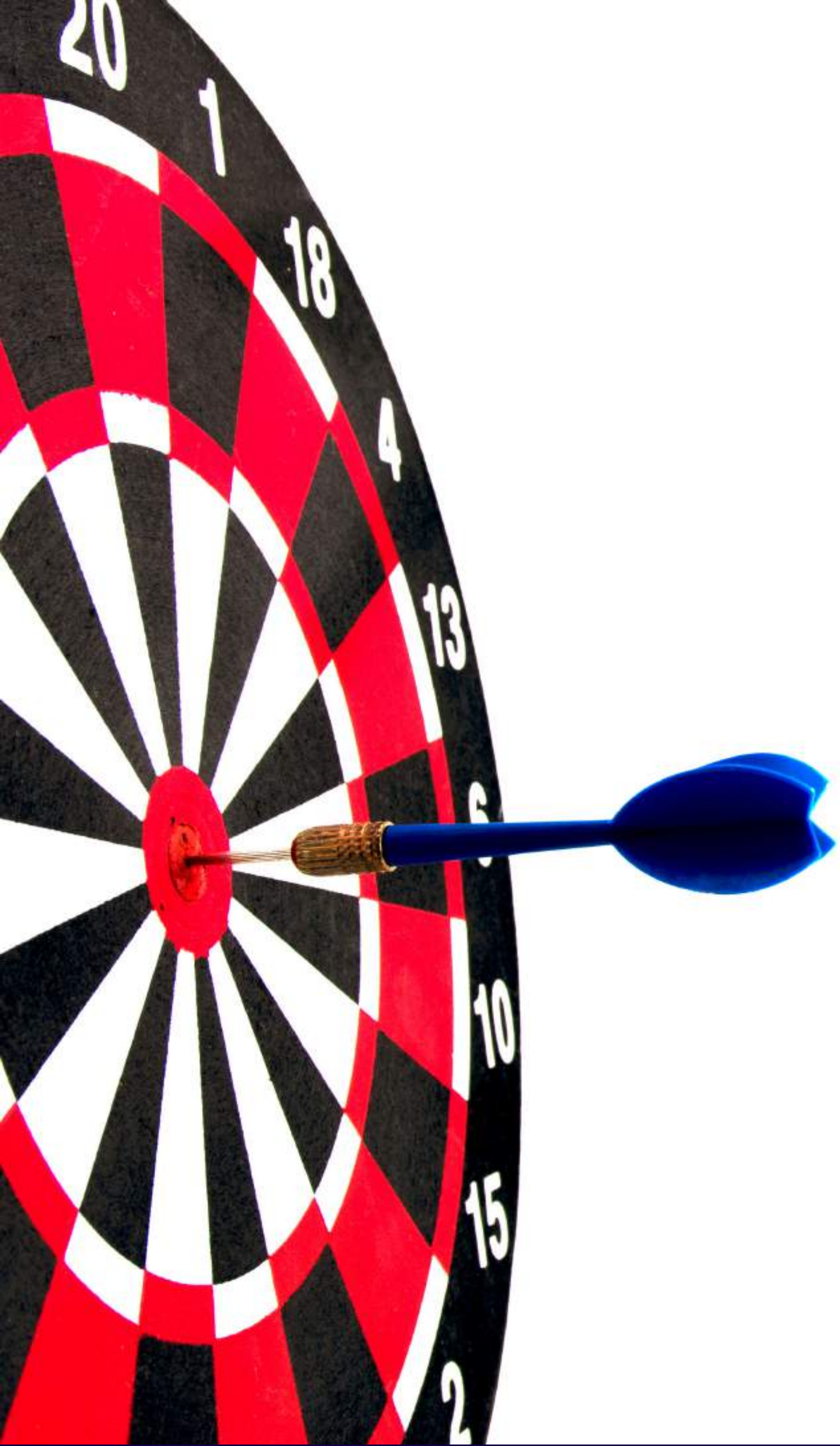
Now, get a pen-paper or do this in excel. We will begin from 01 January 2000 and keep going right as if the prices are moving real-time. Now, we will mark all the candlestick patterns that we observe and write down on pen-paper about the trades that we might have taken based on candlestick formation. We will focus on the right-most candle of the screen and make our decision based on what we would have done if something of this sort were to happen today.

We will practice on the data that was available in the past.

The key is, to be honest, and not look beyond the succeeding candle till the time we have made our decision.
We will go ahead, one bar at a time –making our decisions. This way we will go one by one from 01 Jan 2000 to the current date and at the end see our year on year performance.

5

We will repeat such a practice with other larger companies or else with other indices or commodities, to trade and understand our progress.



Such practice will take hours and days of effort. However, such practice will also make sure that we are completely fluent in candlestick patterns. We will see how it is always easier to see patterns in hindsight, but when we try to understand this with a future-looking perspective, they do not always work the way they are supposed to.

It is only through such practice that we can make sure that we are ready to take active positions in the market and not go to the market under-prepared only to end up paying huge tuition fees in the form of losses. Move to the next analytical tool after practicing this.