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TRADING STRATEGY SERIES

02. Technical analysis:

5 Trading Tips that Will Ignite Your Trading

Overview

This is the second of a series of mini e-books from FP Markets designed to provide you with trading strategies and a guide to some of the technical and charting tools used by the best traders to maximise their returns and minimise trading errors. For any strategy you implement, the aim is to make sure the potential reward is greater than the total risk, and that wins on good trades more than cover the smaller losses on losing trades. To be a successful trader you will require discipline, planning and careful reflection to refine your skills.

Each of our mini e-books will include:

• A section on trade planning with suggestions on how to prepare for trading

• A trading strategy with notes on technical analysis

• A description of one of the standard trading tools

01 Trade Planning: Keeping a Trading Diary

If you're a 'seat of the pants' trader, making trading decisions based on news and your gut feel about where the markets are going, and never keeping track of your wins and losses, the chances are that in the long term you will simply whittle away your trading capital.

Those who don't track their performance have little chance of improving on it because it is difficult to learn from experience if that experience is quickly forgotten. For each trade you make, it's essential to record the following details:

• The date of the trade and the entry price

• The initial margin paid

• Rationale for entering the trade

• The exit price and all costs incurred

• Rationale for the exit

• The position size (in dollars)

• Time period for which the trade was held (in days)

• The net profit or loss on the trade

• Any thoughts about the trade experience. Was the trade correct in terms of procedure, position size and risk management? Would I do it differently next time?

Keeping these records will enable you to see more clearly where and how your trading performance needs improvement. For example, you will be able to calculate:

YOUR WIN/LOSS RATIO

This is the number of winning trades compared to those that lost money. This statistic will allow you to estimate your win-loss probability. For example, if you win on three trades out of ten, on average, your win/loss ratio will be 1:3 and your probability of making a winning trade will be 30%. This may be enough to provide overall profits, depending on how much you win or lose on each trade.

AVERAGE WIN/LOSS

Average dollar amounts won and average dollar amounts lost on each trade. If the size of your average win is $200 and the size of your average loss is $100, your system needs attention (unless you have a very high win/loss ratio). If you only win on three trades out of ten, you're going backwards after ten trades – three wins will net you $600, but the seven accompanying losses will cost $700. It's time to review how you set stop-losses, decide position sizes, and your entry and exit procedures.

WIN/LOSS PER DOLLAR INVESTED

The amount you paid as initial margin divided by the win or loss on the trade tells you how much you have won or lost per dollar invested. If your average initial margin is $500 and you make $700 on the average winning trade, your gain per dollar invested in winning trades is $1.40. You also need to calculate the average loss per dollar invested in losing trades.

02 Technical Analysis:
Moving Average/Bollinger Bands

Technical analysis is the study of changes in price and volume as a way of calculating the probability that a price will move, or keep moving, in a particular direction.

Charts don't make predictions – in fact, markets are by their nature unpredictable. But people are not. They tend to overreact, first in one direction and then in another, and charts can help in identifying possible turning points for CFD trades by showing whether a trend is in full flight or losing momentum and about to turn.

TREND FOLLOWING STRATEGIES

Following a trend is easier if you have a way of measuring it, and determining the likelihood that it will continue or reverse. You can analyse a trend using a number of indicators, including moving averages and Bollinger bands, which add an additional layer of information, refining the analysis to give a more detailed picture of the market's action than the trend line alone.

1 MOVING AVERAGES

Take the closing price of a share on each of the past ten days, add them and divide by ten. Plot the figure on the bar chart along with today's prices. Repeat the procedure the next day, dropping the oldest price and inserting the latest, and you're now plotting a ten-day moving average.

Ten days, 30 days, 50 days and 200 days are among the typical averages used, but moving averages can be calculated over any number of days. A share index or commodity that has been trading below its moving average and whose price rises above the moving average is giving a possible buy signal. The longer the period of the moving average, the more reliable the signal tends to be; the shorter the period, the earlier the signal. Finding

the optimum trade-off between these two for the share index or commodity CFD you're trading involves doing some research into its past behaviour.

A popular type of moving average is one that is weighted to give recent prices more effect on the average than prices on earlier days. Analysts use such a weighted, or exponentially weighted, moving average because they take the view that of past movements, those that occurred more recently are likely to provide a more accurate guide to future moves. In practice, there is not usually much difference between their performances.

The question as to how many days the average should be calculated over can be answered fairly easily using the tools available on the FP Markets trading platform. Using past data, you can calculate moving averages over any period, comparing them on the chart to see which ones have the earliest and most reliable signals.

CHART: 50-DAY SIMPLE MOVING AVERAGE

WHAT A MOVING AVERAGE SHOWS

As the accompanying chart shows, a moving average smooths out the daily price jumps and gaps in the chart, enabling you to focus on identifying and following any trends. As a price decline reverses and the price begins to rise, it may move up to a point

higher than the moving average. A strong upward move through the moving average is a buy signal – an indication that prices will probably keep rising. While the price remains above the moving average, hold the long position. As prices start to fall, they often reach the moving average and then resume their upward move. If the price moves down through the moving average, a sell signal is generated. It indicates that the downward move is getting stronger and will probably continue. Consider exiting long positions, and the possibility of entering short positions if there are any other indications of a decline.

MOVING AVERAGE CROSSOVER

In the search for better results than a simple moving average can give, chartists also calculate moving averages for more than one period and look for places where the longer term average crosses the shorter term or vice versa. Suppose you are plotting both a 10-day and a 50-day moving average. The simplest strategy is to buy when the shorter-term (10-day) moving average moves up through the longer-term (50-day) moving average line. Conversely, if the 10-day moving average falls below the 50-day moving average line, this is a sell signal.

CHART: 50-DAY AND 10-DAY SIMPLE MOVING AVERAGE CROSS-OVER

MOVING AVERAGES IN CONJUNCTION WITH OTHER SIGNALS

Moving averages used alone can indicate the progress of a trend, but trades with a higher probability of success may be achieved by using them in conjunction with such other chart elements

as support and resistance. For example, a market may have a strong support level – a level where fresh buying has repeatedly prevented further decline. If a moving average signal combines with a break through a support level, the trade has a higher chance of success. Similarly, look for penetration of previous resistance levels (levels where the price tends to attract sellers, halting the rise) as a price moves up. A convergence of a moving average signal and a break through resistance gives a signal that has a higher probability of success than the moving average signal alone.

CHART: 50-DAY AND 10-DAY SIMPLE MOVING AVERAGE CROSS-OVER CONFIRM A BREAK OF RESISTANCE

03 Fibonacci Retracement

Named after a mathematician, the Fibonacci series has been shown to reflect the way growth occurs naturally in living systems. The series starts with 1 and each subsequent number in the series is the addition of the previous two. The second number is also 1 (1 being added to zero to give this result). The series is infinite, but starts with the following set of numbers:

1, 1, 2, 3, 5, 8, 13, 21, 33, 54, 87, 141...

It's the ratios between two consecutive or alternate numbers in the series that gives us the levels of Fibonacci retracement that often become support and resistance levels. For example, one important ratio, the 61.8% level, is derived by dividing any number in the sequence (after the first few) by the next in the series. For example, 54/33= 0.618 or 61.8%, known for centuries as the golden ratio or golden mean. Other important Fibonacci ratios are 38.2% (54/141), 50% (1/2) and 100% (1/1).

The concept of retracement involves plotting the distance between a recent low point, at the start of a trend, and the high point at which the trend began to reverse. The theory states that after a big move, the price will tend to retrace by a percentage equal to one of these ratios. So if it has moved up it is likely
to drop at least 38.2%, and if it keeps falling will probably fall to the next retracement level, 50% of the distance on the way down from the high back to the previous low. A break through one of these retracement levels on the way down is like a break through a support level, and indicates a further retracement to the next Fibonacci level below.

CHART: FIBONACCI RETRACEMENT LEVELS

Where a technical support or resistance level is close to a Fibonacci retracement level, a break through both levels is a stronger signal than either of these alone.

04 Bollinger Bands

Bollinger bands, developed in the 1980s by trader John Bollinger, are probability indicators plotted either side of a moving average. As the market becomes more volatile, the bands widen, and show when the price has moved beyond the level expected statistically – that is, beyond the bounds of probability based on the price volatility. Such a move signals a possible price reversal.

Another way to use Bollinger bands is to buy when the price moves to the lower band and sell when it reaches the top. Bollinger bands, in conjunction with signals generated by moving averages and Fibonacci retracements, add another level of confirmation to the probability of a possible price reversal.

CHART: BOLLINGER BANDS WITH A 30-DAY PERIOD MOVING AVERAGE

05 Trading Tools: The Trailing Stop

Knowing where you will exit from the market if you make a profit is just as important as knowing where to cut your losses.

The two-part golden rule of trading is 'cut your losses, let your profits run'. Both can be a challenge to adhere to, but stop-losses take much of the stress out of the process by giving you predetermined exit points, or conditions under which you will close your position at a profit. Taking a profit just because it is there will be counterproductive if the market has more to offer, and if your winning trades are to be enough to more than cover your inevitable trading losses.

The stop-loss that gets you out of the market when it starts moving against you can also be turned in your favour to ensure that profits are preserved when your position is still open, but showing profits on paper. Paper profits can quickly disappear if there is a sudden price reversal, so the idea of a trailing stop is to constantly move the stop-loss price closer to the current price as the market moves in your favour.

Suppose you open a long position in gold at $US1725, placing your stop-loss with reference to support levels and gold's daily trading range at $US1680. The first step in executing the trailing stop will be to move the stop-loss point to break-even ($US1725) as quickly as possible – that is, as soon as the market price moves above this level to a point you have previously decided on. Now, if the market moves down again, your exit is not at a loss apart from trading costs.

As the gold price keeps moving up, the stop-loss level moves with it. The question is, if gold moves to $US1780, how far below it should I place the trailing stop? Traders often use a fixed percentage price move, such as 1 per cent or 3 per cent, but others attempt to be more precise by looking at gold's volatility and how far it has fallen recently before its fall can be considered a reversal.

Average true range (ATR) is a way of using the market's own data to determine how far away your trailing stop should be from the market price – in this case, below it. The average true range is normally taken over a period of 14 days and is the moving average of the daily true range. Daily true range, in turn, is the greatest of three different ranges – the high minus the low, today's high minus the previous close, and today's low minus the previous close. It is different from the actual daily range because it takes into account any gaps between a previous close and today's opening.

Clearly you wish to protect profits without being stopped out too early, but it will take some back testing to discover where this point is most likely to be for your gold trade. Traders often use a multiple of ATR in order to ensure the market has room to move before the stop is triggered – typically a multiple of 1.5 or 2 times ATR. So if gold's ATR is current $25 an ounce, your stop would be set at $37.50 an ounce (using 1.5 times ATR) or $50 an ounce (using 2 times ATR).

Summary

In summary this series will deliver trading strategies and frame these with helpful information that will help you improve as a trader.

This e-book first looks at the trading diary as a way of monitoring your trading performance to see if it needs improvement. It discusses moving averages, Fibonacci retracement and Bollinger bands as ways of determining the current trend, since it is the trend that makes the trade. Finally, it looks at how to use trailing stops to protect profits and determine the best profitable exit point for your trades.

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