



# Learning Center

## D02 Chapter 02

### Combining Edges

1. Finding The Edge
2. Concepts That Work
3. Flexible Tactics
4. Exit Strategies



Topics covered in this chapter:

- Highly-effective, dynamic combinations of trading concepts you can use to design great strategies.
- The mechanisms you have to master to trade financial markets during unstable economic times.
- How to design a system with strategies for all types of market conditions: trending, reversing and ranging.
- A special focus on exit strategies: stop-setting, trade management and target-placing.

There is a wide array of technical approaches to trade the Forex as we have seen so far. Some are better suited to particular trading profiles and styles than others. **This chapter will focus on a selection of trading concepts we have found to be consistently helpful in interpreting market behavior and making price forecasts.**

While outlining some of the basic tenets of each strategy, a fully understanding all of the methods requires you to read the original studies by clicking on the links. The aim of this chapter is not so much centered on the strategies themselves, but rather on how they can be used in conjunction, making you understand that strategies can be combined into powerful trading models.

The first section will give you a general overview of what a strategy is and why the buy and hold mentality can not serve you in the currency market.

The second and third sections cover entry methods for several market conditions. In contrast to [Chapter C04](#), where we have focused on the strengths of many of our experts, this time we want to explore a bit further what strategies they use and how they combine them into fully-flexible trading models.

The fourth section takes on one of the biggest myths about trading, namely, that successful entry techniques are what will lead you to consistent profits. There are literally thousands of ways of entering trades, as more and more indicators and trading strategies are developed over time. But the truth is entries are just one component, along with so many other factors which, once combined, can truly lead to consistent results. For this reason, section three will focus on exit strategies and outline several methods to trail stops and project targets.

Please note, once again, that there is no such thing as a secret trading formula. Most of the methods used by our experts are publicly available. It's how you sum the edges that will make a difference.

# 1. Finding The Edge

## The Land Of Confusion

As we have seen in Chapter B04, most of the experts develop personal strategies and over time they shape them to perfectly fit their needs and capabilities. Some of them focus on one particular indicator or pattern, while others use broad spectrum analysis to determine their trades. But the most important thing is that all of them suggest trying a combination of resources in order to make price projections and determine entry and exit points. Through persistent research and practice they have decided what works best for them.

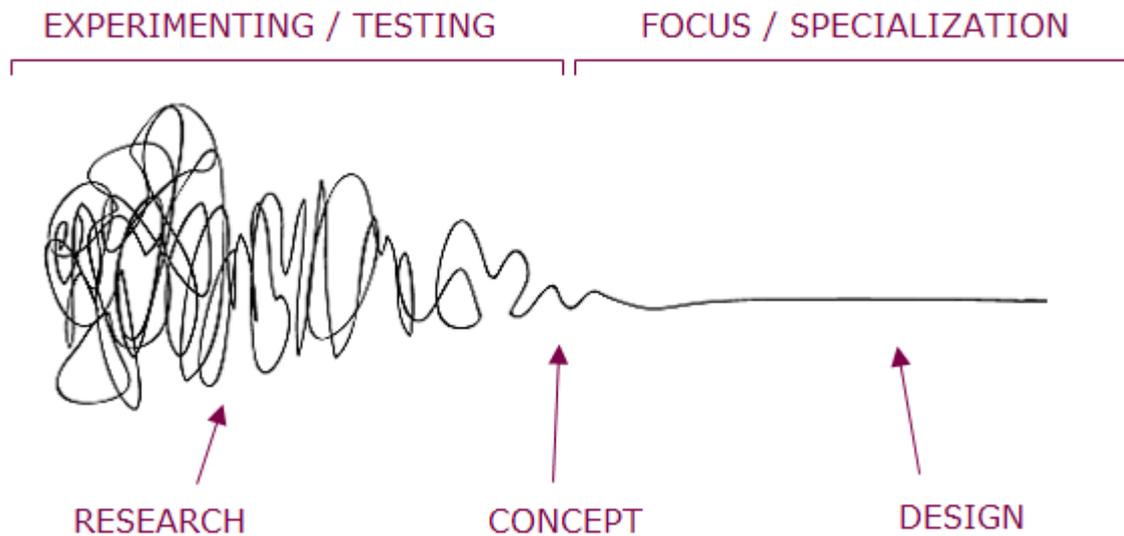
Basically speaking, a strategy consist in using proper indicators in order to analyze a financial instrument and thereby obtain clear signals as to when to profit from a price move. These indicators can be of a technical or fundamental nature, and strategies can use one either type or be a combination of both.

**With every advantage that any strategy presents, there is always a disadvantage to the technique. That is why we promote the combined use of strategies. Just like many heads, several indicators are usually better than one!**

Nothing in trading works 100% of the time. There is always a certain level of unpredictability to the markets and what traders seek to do is to have a legitimate edge which helps to turn the odds in their favor. As you proceed through the chapter, you will notice that we reintroduce many of the trading concepts, these so-called "edges", gained from previous lessons. These, combined with expert strategies, will provide you with enough material to build a versatile and robust trading model of your own.

We suggest you follow a certain order in the way you add tools and techniques to your trading arsenal, and that go on building your method step-by-step. Throughout our educational material, you will find many ideas and lessons on how to trade certain set-ups.

The image below illustrates the process of exploring endless possibilities, through establishing tradable concepts, up to maturing a system design. The initial disorientation gradually shifts into a focused discipline.



At this stage you are probably able to recognize a [trend](#)-following method from a range-trading or a counter-[trend](#) method. The reason why different methods are categorized according to the market condition may lead you to think that market phases are easy to differentiate, but they aren't. It remains a subjective issue in itself, but within this frame of subjectivity you can find your own objectivity. What do we mean by this?

What all traders ultimately aim for is to adhere to price, enter the market and follow it for a while, and exit with a profit. From this perspective, you always go where the price goes—even if the price is trending, ranging or reversing from a technical point of view.

**Based on this principle, the starting point when designing a strategy is to define what the trending condition is. This is important because if you don't know how to recognize a [trend](#) you can't know how to define a ranging condition. Following the same logic, the elements used to identify a ranging market will allow the trader to know when is best to apply a counter-[trend](#) strategy.**

By the end of this chapter you should be geared with additional concepts on how to trade in all three market conditions. This will hopefully enable you to participate in those difficult situations where you usually stand aside. In order to do this, it's obvious you should be able to understand the importance to build a trading model that is able to objectively categorize market conditions and ideally enable you to trade in all of them.

## Bundle Strategies For Different Market Conditions

Van Tharp points to the difference between the buy-and-hold investment strategy and a

structured and systematic trading approach. The first tactic, employed by many equity investors which appeared to be working quite nicely during the extended bull market up to the latter stages of 2007, has proved disastrous as the market collapsed afterward. **Now more than ever, anyone wanting to profit in financial markets has to master much more versatile techniques because of increased volatility and risk in the financial markets.** Van Tharp recalls those one-directional, bull-market times by explaining:

“ In 1999, everyone in America seemed to be a stock market expert. For example, we were giving a stock market workshop at the Embassy Suites in Cary, North Carolina and one of the bartenders said to the other, “Perhaps we should take Dr. Tharp’s Stock Market Workshop.” The other one responded, “No, I don’t need that. I could teach a workshop like that.” Similarly, a waiter in a high-class steak restaurant informed us that he was really a trader, but that he works at a restaurant part-time at night. He had already made over \$400,000 trading and considered himself to be an expert trader. However, my guess is that those people did not survive the markets from 2000 to 2002, much less the market we have seen in 2008. Why? They are different markets, and a strategy of buying and holding high tech stocks that worked in 1999, had mixed to horrible results in the years since 1999.

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Kel Butcher points to the same phenomena in one of his articles:

“ ...these people were throwing money into the market on a whim in order to be part of the action, and make their fortune share trading ‘in as little as one hour a day’. Unfortunately, they had no real idea of what they were doing. Nor did they have an understanding of the concepts of risk management and money management. Over exposure, lack of a trading plan, and disdain for money-management concepts wreaked havoc when the market crashed. Cash margin calls, the forced sale of shares and, in some cases, other assets to meet margin calls added more fuel to an already raging inferno. [...] Actively managing your share portfolio – cutting losing trades, knowing where and when to exit profitable trades, understanding money-management and position-sizing techniques – is the only way to ensure success in any market.

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When comparing currency trading with other investment vehicles, Joseph James Gelet states that trading in the Forex is a **"market neutral" type of investing**, since you are not buying or selling anything. Traders are instead exchanging- which is a different and challenging concept for many neophytes. About trading in unstable time, he writes:



In a bad economy, where do profits exist? How does one identify the right opportunity? Most traditional investments, i.e. stocks, bonds, and commodities, are connected to the real economy. In other words, they depend on sales by consumers and other businesses. Even the price of oil has a [demand](#) function, if businesses are closing and purchasing less oil, the price will fall. Companies that sell a product, even a necessary product, depend on consumers. 75% of US GDP depends on the US Consumer, who has less money and available credit than ever before. Even if you have the best product in the world, if customers don't have money to buy, it's difficult to sell.

A market neutral Forex system doesn't have any product, it trades money for money. Europeans have a [demand](#) for Dollars and Yen just as Americans have [demand](#) for Euros and Pounds. Whether the dollar goes up or down, as long as the US economy exists, someone somewhere will have a [demand](#) to trade Dollars. This means there are constant opportunities for buying and selling – the key is to trade actively and not take a major position on market direction, and to cut the losses and ride the gains.

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Detaching from the need to be right on every entry is, besides a psychological goal, an important aspect when developing a trading method. Should any strategy you come up with know what the direction of the dollar will be in the next hours or tomorrow? The answer is simply: no, and you should not care about it at all. **Forecasting the direction of currencies is much more difficult, to say the least, then deciding what to do if prices go up and what to do if it goes down.**

A market neutral system, build of several strategies, should run in any type of market, hence the name "market neutral". That doesn't mean it's infallible, this statement is simply contrasting a versatile trading approach with the traditional buy and hold method.

## Know Your Strategies

Building strategies can be fun, easy and surprisingly quick. You don't need to spend thousands of dollars looking for a great trading strategy. We will show you several concepts on which you can develop great strategies.

Besides, **developing strategies on concepts that work makes it much easier to stick to your trading plan and even more so if the strategies are the result of your own work.** A complete understanding of the rules behind our trading systems means the trader understands why they are generating specific signals at all times as well as the concepts behind them. If you understand the series of events that occurred to make a buy or sell signal happen, you will have the ability to repeat that action consistently.

A good trader who is able to continually adjust their system design to adapt to changing market conditions should also have the confidence to execute each trade with a high degree of certainty that the odds are favorable.

This is easier said than done. So let's get down to business.

## 2. Concepts That Work

Ask any technical trader how he or she profits from the market and you will get probably two types of answers. Depending on his or her answer, you will see if he or she is an experienced trader or not. If the trader is inexperienced, he or she will point you to an indicator. "This indicator with such setting is needed to effectively determine price patterns," is more or less the usual answer. On the other hand, the experienced trader will transmit you in a few sentences what the concept he or she tries to capitalize on.

**In reality, anything that one indicator can do, two complimentary indicators can do it equally well or better. It's not so much about the tools, it's about the concept- here is where you really have to start. Once you get the concept, several tools can be used to the same end.**

Technical analysis techniques range from the opaque and incomprehensible to amazingly straightforward and stunningly effective. From a practical and educational point of view, the second group is favored. The selection of trading concepts discussed below aims to pick the essence of some effective strategies used by our experts and extract the ideas which lie behind them.

The reason why previous Units deal with the trading mechanics and types of analysis and tools was to prepare the student to make better use of more complex lessons. There is now a greater probability that you will not just copy the tactics presented here, but rather make them you own. Should you have just breezed through the previous tutorials, you can always check back as they are the foundation of your trading education. But now you are in a position to develop that knowledge into something more personal. Your sense of analysis is more accurate, and you can start to combine the elements creatively.

### Comprehension + Confirmation = Confidence

The above title is Raghee Horner's formula to put all the pieces together. **Comprehension** is about understanding what you are using. If you decide to use an oscillator, it's not because someone says it works, but because you know what this tool is for- maybe you have seen how it is calculated, you are familiar with its pros and cons, and you have tested it on your own. Adopting or supplanting any tool will always hinge on whether the tool is useful for your decision making or not.

And here is where **Confirmation** starts: you acquire the confirmation by verifying and testing. Note that testing is not just plotting the tool on the [chart](#), you want to see it across multiple pairs, multiple time frames, and under several market conditions.

If we see a strategy working, each trade will further confirm that you're doing the correct thing. Whether it takes a short time or a large time to accomplish it, that will depend on many factors but not on the tools themselves, so please don't spend your time switching tools without a proper method. Do your homework! Every trader has a different threshold for confidence and once you earn it, protect it, just like capital. Once you have visual conformation that an indicator supports your concept, you start to gain **Confidence**, the third "C" from Raghee's formula.

Raghee, like all our experts, are great communicators and will transmit their ideas and concepts intelligently. But that will not save you from going through all the required stages.

## Prepare To Anticipate The Crowd

Identifying and executing low-risk entries are the hallmark of a consistently profitable trader. Sometimes this involves acting against what seems evident on a [chart](#). Let's recall our lessons on price action by quoting Gabe Velazquez, "If you can't spot it, don't trade it," from his article in The Trader's Journal:

“Of all the facets of trading, the first that a new trader must learn before he can engage the markets with any degree of confidence is the identification of low-risk entries on a price [chart](#). Notice that not just any entry will do, it must be those entries offering the biggest reward for the least amount of loss potential.

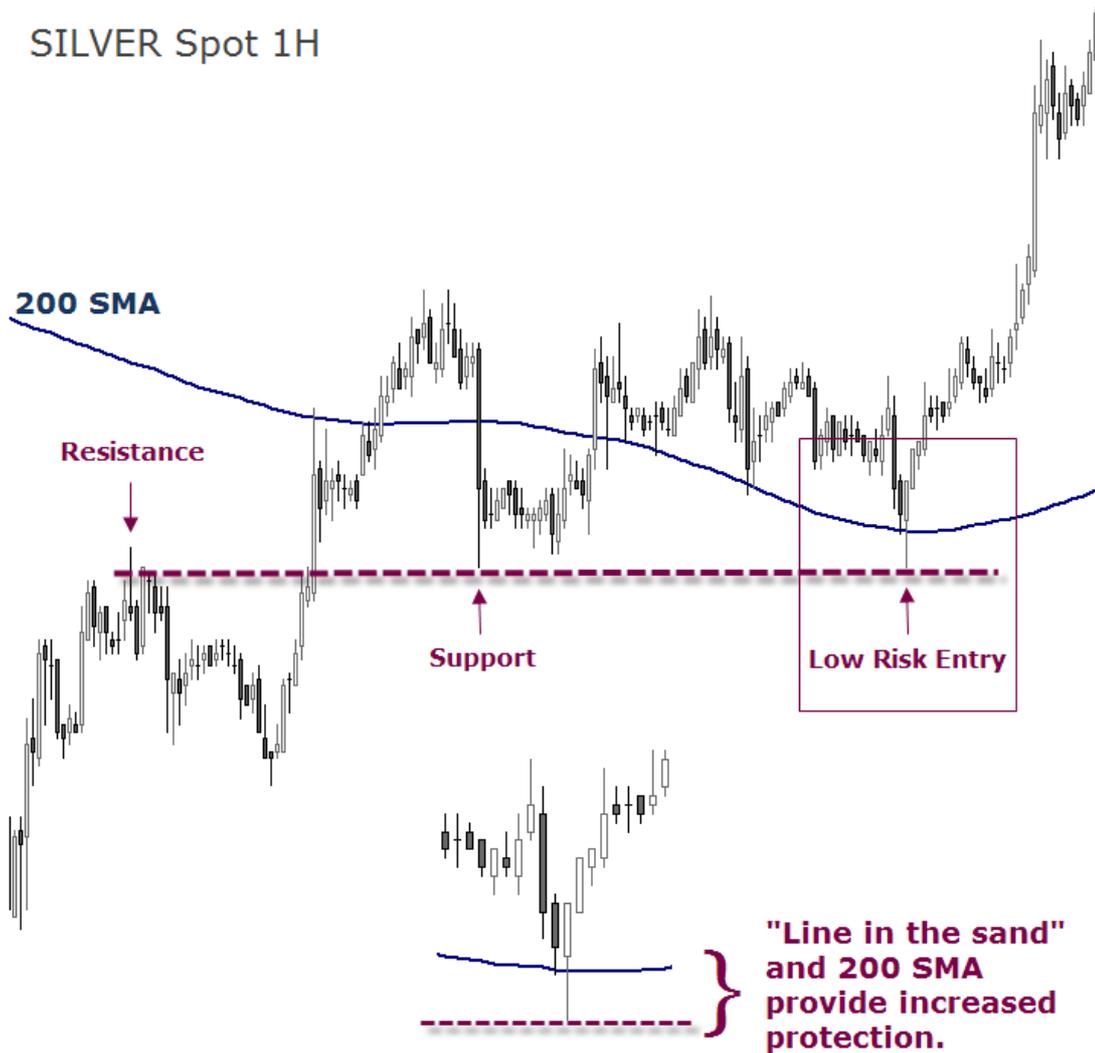
If you have ever read about or had the chance to chat with any successful trader, you will find one common thread. They all (without exception) have an edge based on low-risk entries.

What defines a low-risk entry? I define it as the following– the price level where a trader can expose the least amount of capital to prove whether his edge will work. I tell students to look for these areas by identifying "the line in the sand" or "drop-dead level" where price has to hold. Generally, these are found at prior inflection points on the [chart](#).

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The below image shows an example of a low-risk entry level. Notice how the proximity of the recent support and the 200-SMA provide effective protection for an eventual stop-loss placement.

SILVER Spot 1H



“ Once a trader learns the skill of identifying these levels, the biggest challenge is putting on the trades. Why do I say this? All of these trades were being placed when price is either retracing or the market was moving strongly into one of these areas. If you look closely at these [charts](#), you will notice that you were buying into a series of red candles or shorting into a sequence of green candles (some of them very tall). Psychologically, this does not set well with most non-professional traders. Only by knowing probabilities and accepting risk can a trader place these trades with self-assurance. Indeed, this style of trading is perhaps not for everyone, but regardless of your method, identifying and executing low-risk entries are the hallmark of a consistently profitable trader.

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## Develop Several Strategies

Van Tharp recommends:

“ Develop several strategies that fit your view of the big picture and understand how each of these strategies will perform under various market types. The ultimate goal of this step is to develop something that will work well under every possible market condition. Actually, it is not that hard to develop a good strategy for any particular market condition (including quiet, sideways). It is very difficult to develop one strategy that works well under all market conditions – which is what most people try to do.

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## Define Market Conditions

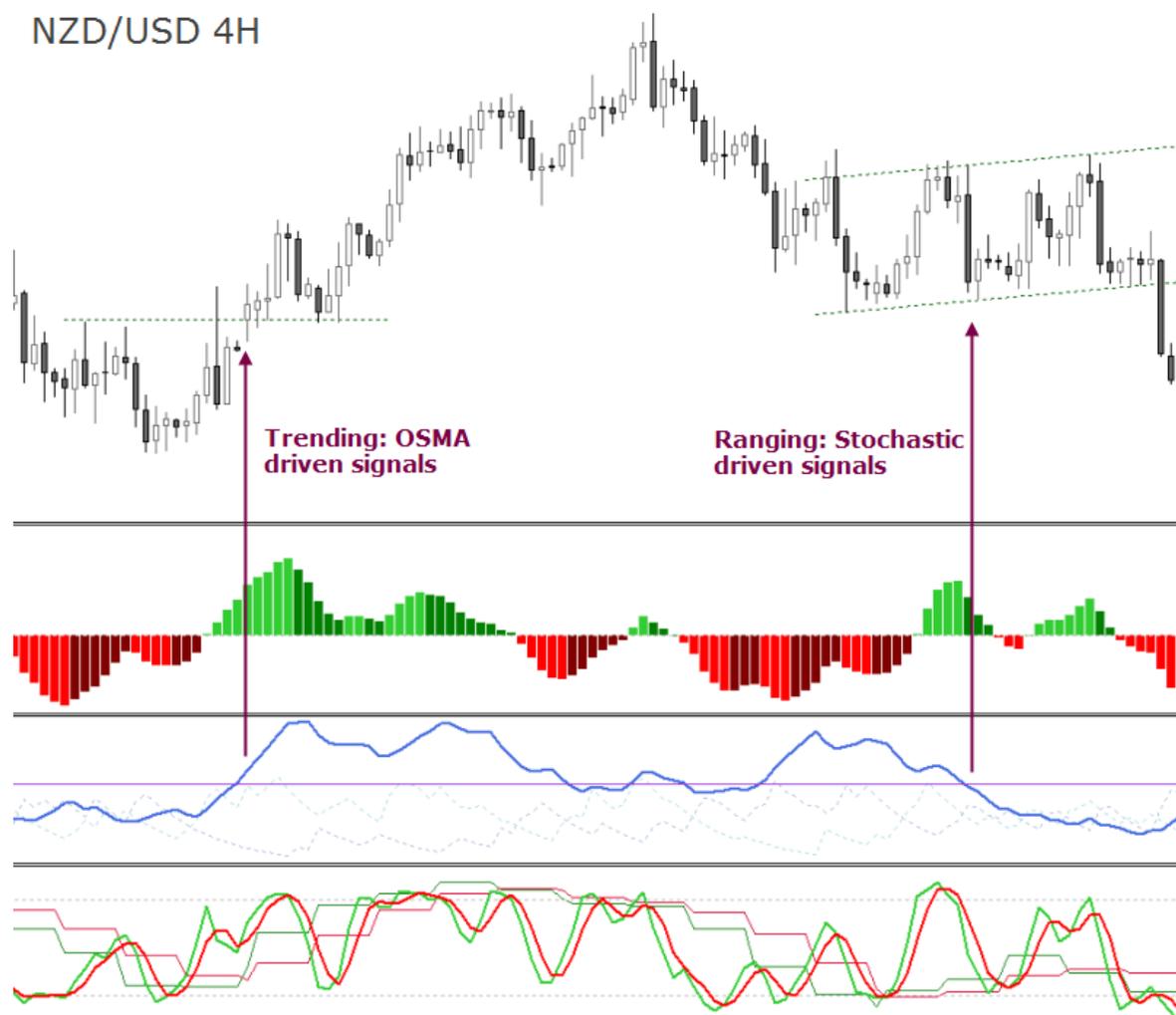
Before you decide what tools to grasp out of your toolbox, you need to know what market condition is currently prevailing . Bob Hunt suggests to differentiate market conditions based on momentum:

“ The nature of day trading requires that the futures trader make a constant assessment as to whether a market is in a trending or trading-range mode. If the mode is determined to be trading-range we need a convenient means of identifying short term reversal points. On the other hand, if the mode is assumed to be trending, we require a means of identifying (1) an appropriate entry point based on the [trend](#) currently in force and (2) an appropriate exit point based on likely [trend](#) exhaustion. An effective means of identifying such short-term [intraday](#) market-turning points involves an evaluation of the momentum behind successive market swings. Price momentum is the measure of the rate, or speed, of price change. Normally, if we are to expect successive market swings to continue creating new highs or new lows, we would expect the rate of price change to increase along with the move to new highs or new lows. If successive swings do not have an increase in momentum, the validity of any new push higher or lower is called into question.

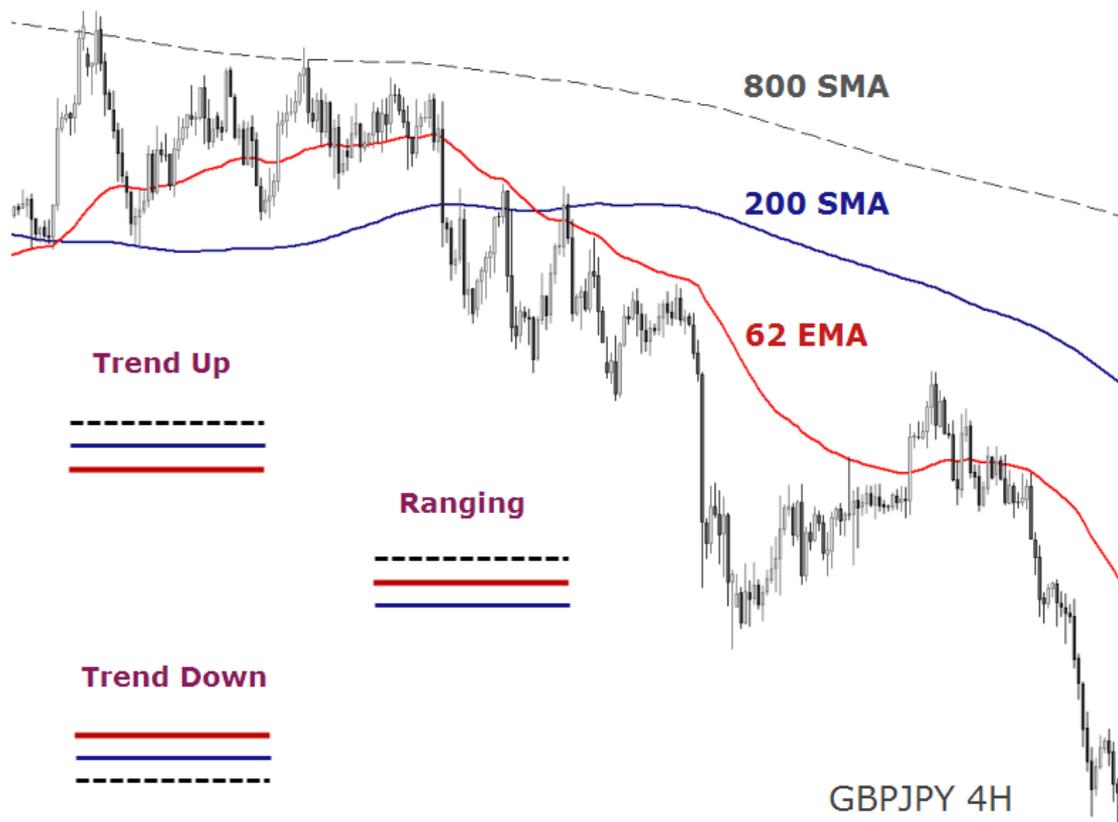
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Several of our experts offer genuine ways to differentiate market conditions. Andrei Pehar, who has a flexible and surgical approach to trading, makes use of the ADX. This indicator tells him whether to use an oscillator for ranging markets or a momentum indicator for trending markets. Andrei likes to quantify the market's condition, and in order to do it he lets a specific indicator give him an objective answer.

The [chart](#) below shows the ADX calculated for the last 14 periods. When its average line shows a value above 30, the market is in a trending mode, and, when it is below 30, the market is in a ranging mode. When the ADX line is above 30, Andrei uses the OSMA indicator to look for momentum, and, when the ADX line is below 30, Pehar switches to an oscillating indicator, in his case, the Stochastic.



Rob Booker, in the context of his Arizona Rules, establishes market phases depending on the alignment of three Moving Averages. The [chart](#) below shows how the GBP/JPY remained ranging while the 62-EMA was between the 800-SMA and the 200-SMA.



Raghee Horner interprets the market as being in one of the 4 cycles depending on the disposition of the wave lines : "mark up", "mark down", "accumulation", and "distribution". The psychological characteristics of each cycle are "greed", "fear", "boredom", and "confusion", respectively. And there is a set-up for each one of these market moods: trending following, [trend](#) reversal, momentum or range-bound set-ups. This is done by interpreting the angle formed by the three EMAs relative to the price/time axis, in the way Charles Dow did.



Find here several recorded webinars by [Raghee Horner](#) to learn more about her "**Wave**" and her "**Lasy Days Lines**".

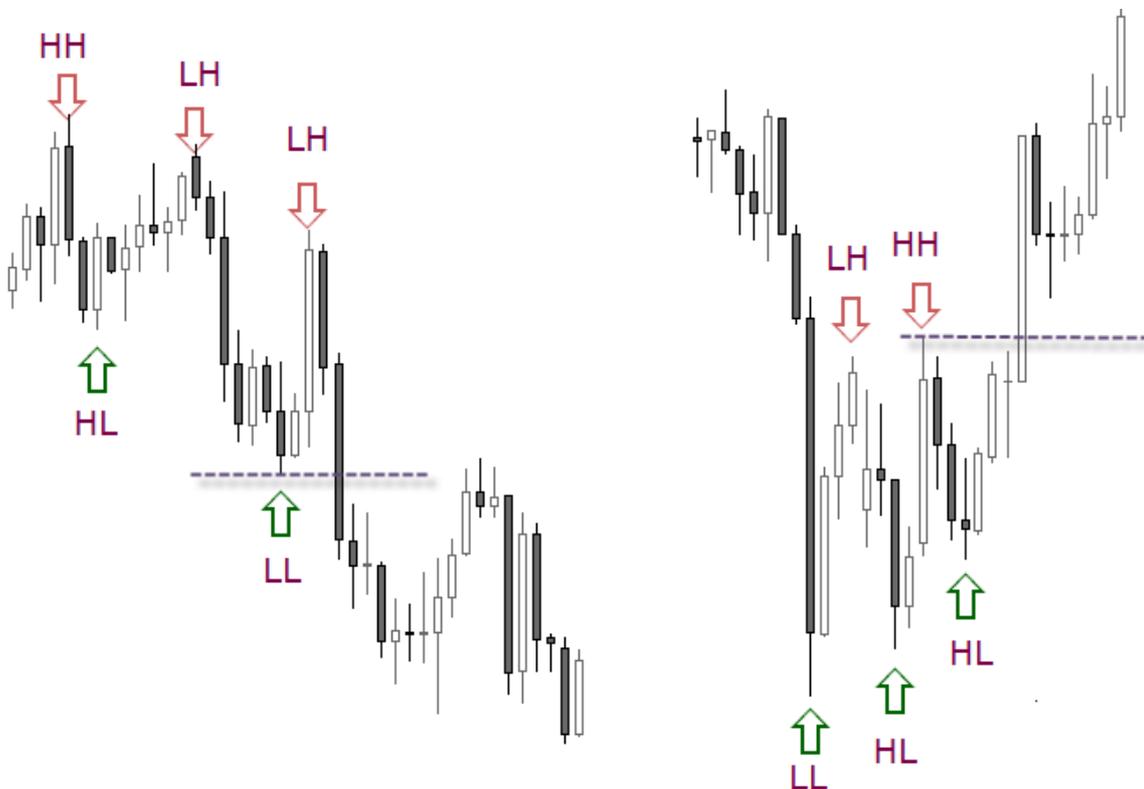
Phil Newton's method, similar to the 1-2-3 rules from classical technical analysis, can be used to detect market phases and bias changes. With this simple method he can answer the question as to where the market is going, if up, down or sideways. His swing high/ swing low definition helps to identify these market phases by a simple

count of these swing highs and lows.

- The market is going up when price is making higher highs and higher lows.
- When price is making lower highs and lower lows, the market is moving downwards.
- When price is not making higher highs and higher lows OR lower highs lower lows, then it is in a ranging mode.

A bias change from long to short (from bullish to bearish) occurs when the following sequence develops: **HH → HL → LH → LL → LH**

When price moves below the last lower low made, the bias change is confirmed (see left side sequence).

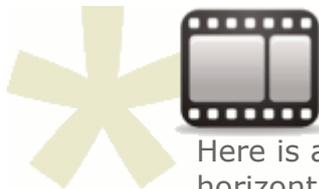


The long or bullish bias change occurs when the opposite sequence develops (see right side sequence): **LL → LH → HL → HH → HL**. The bias change is confirmed when price moves above the last higher high made as highlighted on the [chart](#). Another way of saying this is a 123 reversal and you are trading the pullback as your entry trigger (dotted line).

As for ranging markets, Phil's rules dictate that if price is not making new highs nor new lows, then the mode is ranging.

This happens when price stalls and stops printing new swing highs or lows, and stays contained within the last swing high and low. Until the price doesn't break out of this range, there is no trending condition. Each new swing high or low inside the range just confirms the ranging condition.

**Successful range trading in the Forex market involves more than just visually seeing a range. You have to define what is ranging for you, and trade accordingly. This is the reason why we are showing you different modalities to structure price action: none of them are "truer" or more valid than the others- but they all work well for their developers.**



Here is another original method: range trading is usually associated with horizontal lines on the [chart](#), isn't it? Well, in this case [Andrei Pehar](#) shows you how to use vertical bars to trade ranges!



Our advice is to avoid complex trading methods from the beginning. The reason is because the only elements that can give you an edge are your understanding of the market behavior and the understanding of what your indicators and rules are interpreting the price action. Once that is achieved, by sticking to what the simple indicators say, passing the lessons on psychology ([Chapter D01](#)) and taking all the risk control measures, you should be just fine.



### **Are crosses better suited for range trading?**

Typically, pairs that do not involve the USD are more suitable for range trading because the USD is a trending currency. In general, cross-currency

pairs are more prone to stay within a range. During 2009, for example, pairs such as the EUR/CHF, GBP/CHF, EUR/JPY, AUD/NZD, GBP/JPY, have shown ranging behavior. One exception was probably the GBP/USD which did hold relatively well within a range through the last six months of 2009.

The reason may lie in another factor that can play a large role in determining ranging movements - the interest rate differential between two economies (currencies). Pairs with low interest rate differentials are also suitable for range trading.

But just because certain pairs show these two prerequisites it doesn't mean that the pair will indeed trade within a range for a long time. A currency may experience an increase in volatility because of extreme circumstances and it may take a long time before it stabilizes again.



In this webinar, [James Renshi](#) teaches how he measures ranges, be it tight consolidations of 20-40 **pips** or larger ranges of several hundred **pips** (200-500). To be considered a reliable consolidation though, the market requires a minimum of 5 hours within a tight consolidation during peak trading hours.

## Breakout Nuances

Breakout trading is often associated with price ranges. It can be simple, rule based and very profitable if you don't let emotions interfere with your decision making, either by prematurely entering a trade or by taking high-risk and low-reward set-ups.

Sam Seiden teaches a type of entry breakout strategy to pick those low-risk and high-reward trades. Similar to the "Dop-Base-**Rally**" in Renshi's examples (see above), Sam's set-up also requires that the consolidation area is preceded by a strong movement in price in order to see the probability of a significant breakout increased.



Sam Seiden explains the set-up illustrated above:

“ Notice area “A” in Figure 1 below. Area “A” is the origin of a strong **rally** in price. Most breakout traders will look to buy as price breaks out to the upside from area “A.” This type of breakout entry is typically the “sucker bet.” Traders see price moving higher from [...] area “A” and give in to emotion and buy into that initial **rally**. The problem is that by the time they buy the breakout of area “A,” price has moved so far that it becomes a high risk and low reward trade. Instead, I sit back and let the breakout happen because that breakout tells me that there is a **demand** and supply imbalance at area “A,” this is exactly where the buyers are. Next, I wait for price to return to area “A.”

When it does at “C,” I am a very interested buyer as I am confident that I am buying from a novice seller. I know this because the seller at “C” is making the two mistakes that every consistently losing (novice) trader makes. First, they are selling after a period of selling and they are selling at a price level where **demand** exceeds supply.

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Consider this action-reaction play between **supply and demand** (see [Chapter B04](#)) when adhering to price momentum. This simple technique demands rather complex planning and detached execution though. **Such effective strategies require trading opposite to natural bias, that is, entries on counter-trend reactions and exits on accelerating thrusts.**

**A basic requirement for profiting from impulsive market moves is to align your positions to the underlying trend but against the current crowd emotion.** You may also enter when price is already accelerating but you should not forget to exit when further acceleration happens and never wait for the inevitable pullback.



If you want to fine tune your breakout trading, we suggest you refine Sam's straightforward rules with Andrei Pehar's precision.

In the first half of [this video](#) Andrei explains how to spot a retest of a broken level. There are some nuances to it like how far does the exchange rate has to come back to the range to be an effective "test". Andrei's ideas are much in line with Sam's in the sense that the first breakout is more risky and it's probability much lower. If you want to see precision and flexibility at trading, Andrei is a great example to follow!

## The Bull and Bear Traps

Often, breakouts of a support or **resistance level** don't see sufficient follow through buying or selling. Instead, the market reverses back inside the previous range. Even though the previously quoted experts offer outstanding guidelines on how to trade this price action, we wanted to add Howard Friend's lessons since they follow the same line of thought.

**His theory is that many of the explosive moves in price occur as the result of false breaks of support and resistance levels. This means that for a large move in a given direction to happen a significant number of traders must be incorrectly positioned.**

It's the emotional crowd, the vulnerable traders, who ignite sharp price movements. They chase positions just behind the big volume, where odds of a reversal quickly increase. It's a frequent phenomenon when greed clouds risk awareness.

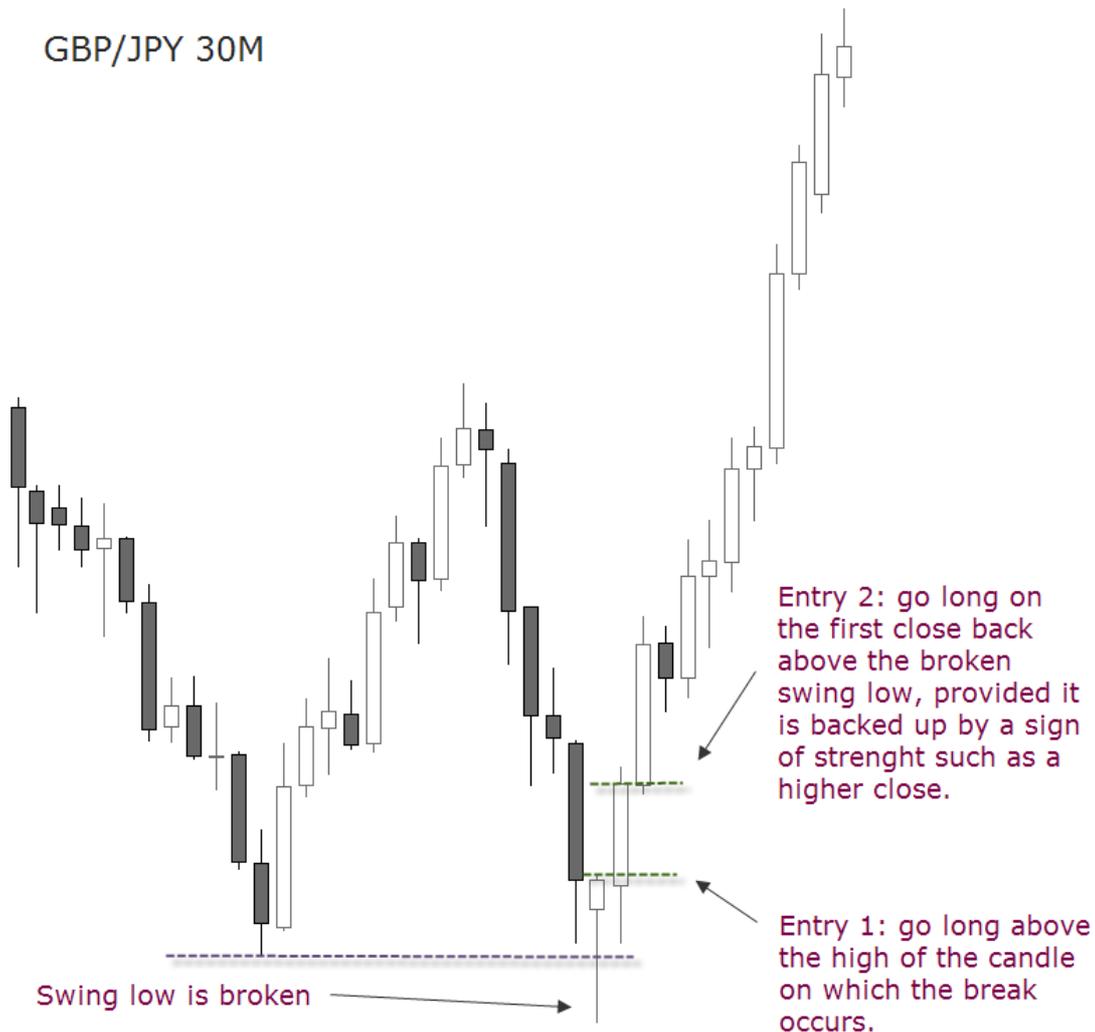
Howard Friend explains:

“ When a **support level** such as a swing low is breached, the market often attracts fresh interest from both buyers and sellers. The ‘buy low’ crowd come in looking for value at previously cheap levels, while the breakout/**trend** following crowd sell the breakout looking for an extension of the decline. If the downside break fails to see follow-through selling, frustrated short sellers cover their positions bidding the market up creating a whipsaw. The market advance is exacerbated by the ‘wait and see’ crowd who come in after most of the cards have been played, and the ‘buy low’ crowd who add to their longs having been rewarded for their bravery in resisting the downside break. The resulting **rally** often lasts for several price bars, presenting a lucrative trading opportunity for the swing trader.

[Continue reading...](#)

There are two ways to entry the position once a “trap” is detected: either you enter with a stop order a few **pips** above the high of the “trap” candle, or you wait for a close in the direction of the “trap” candle”. Notice in the image below when the market breaks above the high of the candle on which the break occurs, that all of the sellers of the swing low break were be trapped and their positions were losing money. They had to cover their short positions, bidding up the price, and this is this move we are trying to capture.

GBP/JPY 30M



**Only unskilled traders fail to consider this rationale when entering momentum trades. They position themselves incorrectly executing market entries on accelerating thrusts.** Once a sharp countertrend starts to destroy their floating profits, their stops contribute to escalate the virulence of the counter move. Only when massive **stop loss** clusters and margin calls are completely detonated, then momentum sinks.

Now you know something more about executing low-risk entries, how to ride a thrust into profits and exiting a subsequent reaction. You can avoid the experience of turning a winning position into a loss using the above defined tactics. The idea is to gear your trading with concepts that work in all kinds of market conditions.

### 3. Flexible Tactics

The objective of the trader who wishes to profit from every market condition is to adhere to a directional price movement while taking advantage of the possible **corrections** or breakouts. However, profiting from a **trend** or price thrust is far more difficult than most participants admit. Especially for a neophyte, it's easy to fall under the spell of a fast price movement. A large Marubozu candle formation, for example, awakens the greed of potential gains and clouds any risk-control measures ([Chapter B04](#)). But an astute trader, looking for the path of least resistance at any given time, will not be lured by the fast price action and will try to act contrary to the crowd.

That prices rarely move in a straight line shouldn't be new to you anymore. Throughout the Learning Center, it has been explained from several points of view how shocks destabilize a market and why counter forces emerge to restrain price back toward its equilibrium. These **constant whipsaws in price exhaust the crowd's money, and once rid of the inexperienced participants, the market proceeds in the most probable direction.**

Under this perspective, divergences are a superb tactic to train the required flexibility to switch from a trending mode to a counter **trend**.

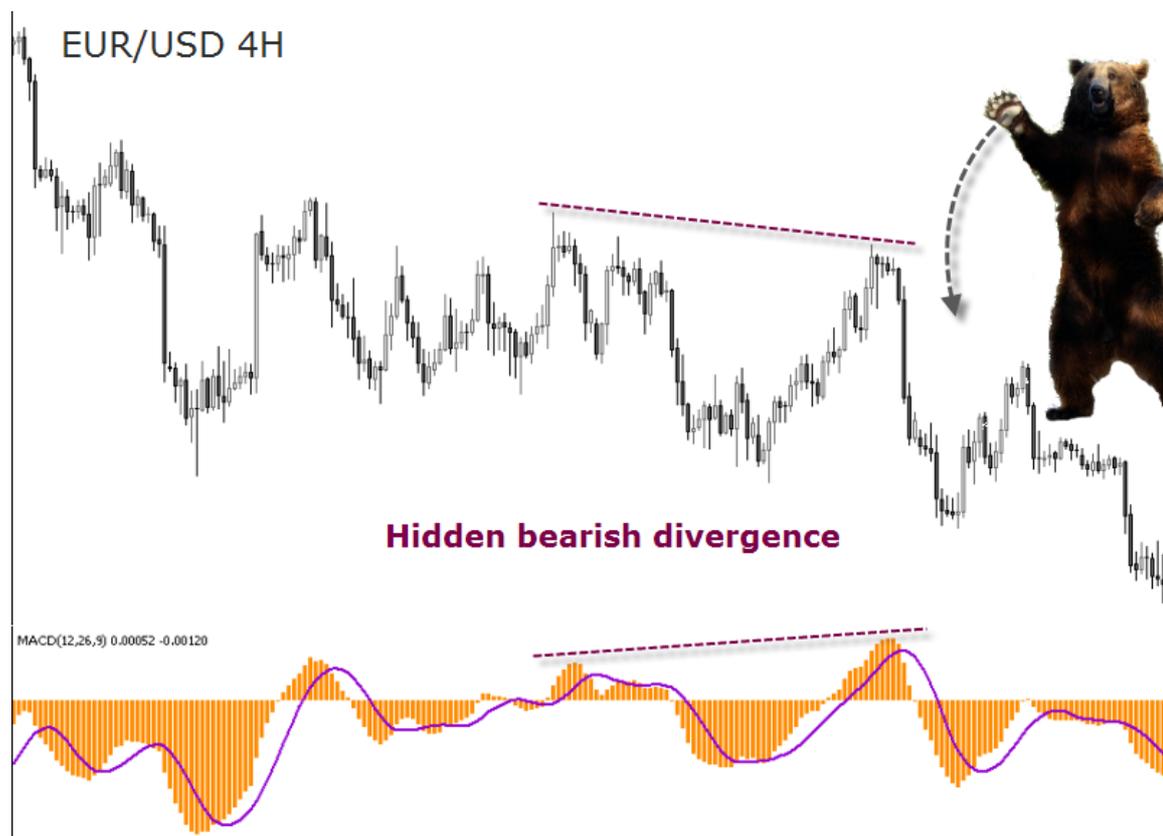
#### Hidden Divergences

While the Regular Divergence is more commonly used (see MACD Divergences in [Chapter B01](#)), the Hidden Divergence is far more effective as Sunil Mangwani explained to us at the 2008 [International Traders Conference](#). Let's see why hidden divergences are an effective way to recognize fake counter-**trend** movements.

The Hidden Divergence, which is a discrepancy between the price and an indicator, can be defined as:

- Bearish Hidden Divergence - Lower highs in the exchange rate and higher highs in the indicator signals a downward movement.
- Bullish Hidden Divergence - Higher lows in the exchange rate and lower lows in the indicator signals an upward movement.

In order to trade divergence set-ups either the **RSI, MACD, CCI, Slow Stochastic, or any other oscillator or momentum indicator can be used.** In the example below, the MACD has been used:



This set-up has the advantage, as Sunil explains, that it follows the prevailing **trend**, and by helping the trader adhere to it, it has a higher probability of success. Another advantage of this set-up is that it provides precise entry, stop and exit levels. He conveys that hidden divergences “act like a catapult” on the price action. In our example, the allegory is a bear attacking from above, and forcing prices down.

“ In an existing **trend**, price makes a pull-back, but the indicator makes a larger pull-back, thus stretching beyond the mean. We would expect the indicator to revert back to its mean, which it does with strong momentum. In the process, price snaps back to its original **trend**, which give way to strong moves.

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A possible question from Practice Chapter PrD would be: If the MACD histogram makes a divergence, does it mean that the MACD is also making a divergence? Acquire ground knowledge and learn a lot of precision tricks with hundreds of similar case studies, illustrated with **charts** and extra explanations.



We suggest developing a trading system comprised of three or four strategies and applying the system to one currency pair rather than using just a single-strategy system and trying to apply it to several pairs. If your system is made of just one strategy, it will probably be made just for one market condition. A tactical diversification is better than diversifying your portfolio by trading several currency pairs at the same time, specially if these pairs are correlated (for example, pairs including the USD).

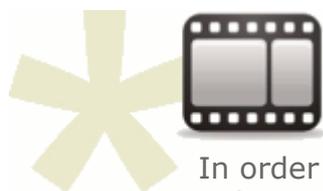
## Regular Divergences

Regular divergences are also high-probability filters for false breakouts - the above mentioned "bear or bull traps". Using a slow stochastic, or a MACD, for example, the trader can see if a break of a support or **resistance levels** has sufficient momentum to continue, or if the odds are the price will reverse below the broken level and start a **trend** in the opposite direction of the breakout.

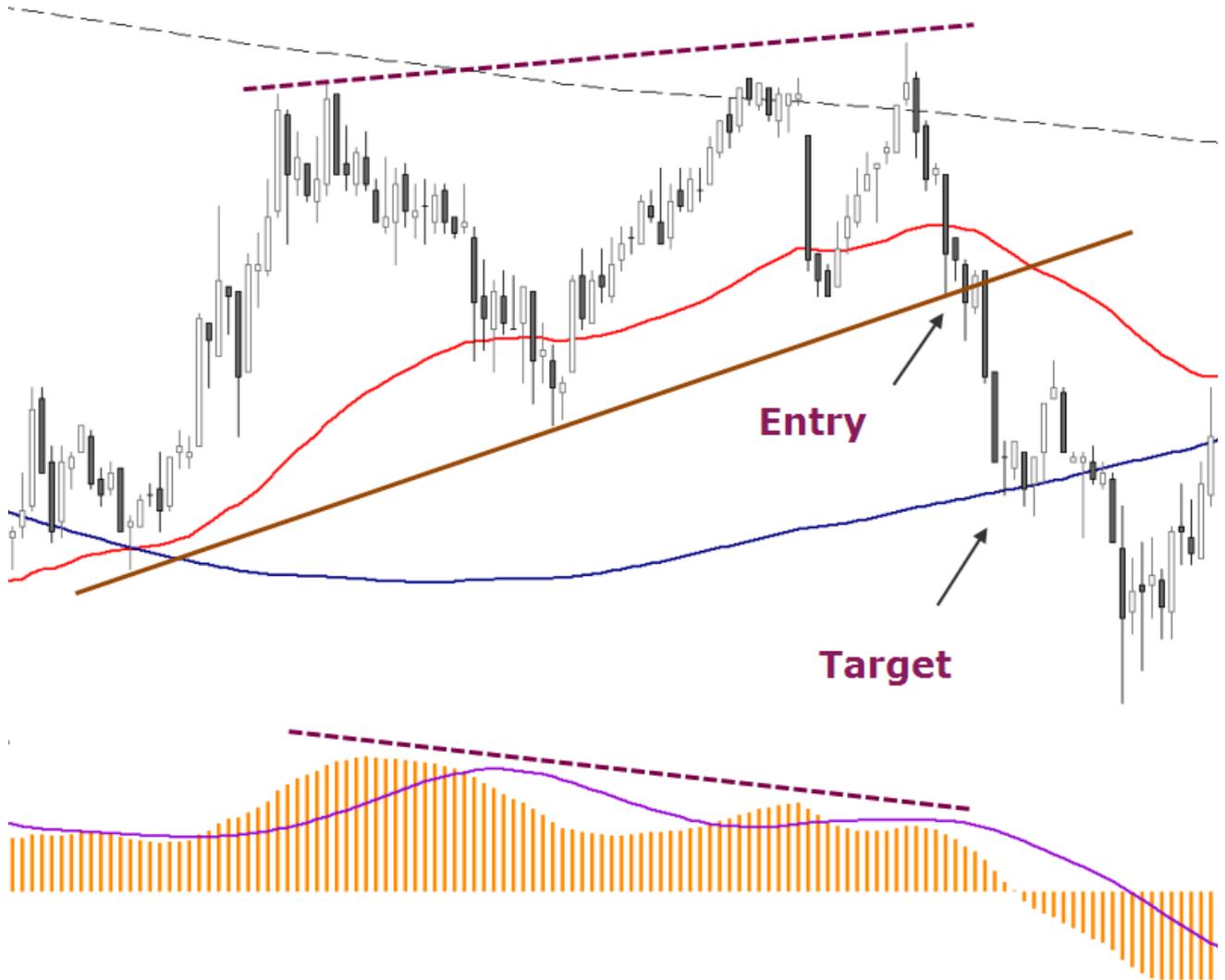
## EUR/USD 4H



### Regular bullish divergence



In order to spot divergences you can also modify the standard setting of the indicators used. [Rob Booker](#), for example, has modified the MACD parameters to identify regular divergences. Remember, regular divergences are counter-**trend** set-ups.



For target and stop-loss setting, Rob uses a combination of the 62 EMA, the 200SMA and the famous 800 SMA. He also adds **trendlines** to the **chart** as additional support and resistance indicators. As for the MACD, instead of the standard 26, 12, 9 parameters, which in his opinion print too many divergences, he prefers the slower ones of **65, 30, 23**.

## Momentum Confirmation

And yet another way to measure divergences is the use of the MACD by setting the short term parameter to 3, the long term parameter to 10, and the smoothing parameter to 1. What it does is basically to subtract the 10-period Exponential Moving Average from the 3-period Exponential Moving Average (see Chapter B01 for more details on the MACD construction).

Bub Hunt calls this adaptive version of the MACD, the **3/10 Oscillator**. What is most interesting in this approach is the distinction from a divergent condition and what the

author calls a "Momentum Confirmation". He explains:

“ When using the 3/10 Oscillator, we are attempting to identify one of two conditions on successive market swings that move to either new highs or to new lows. The first of these conditions is referred to as "Oscillator Divergence" and the second as "Momentum Confirmation". The two terms describe opposite conditions. Typically, each successively greater swing pivot high or swing pivot

low will be accompanied by one or the other.

[...]

In essence, the Oscillator Divergence indicates that the current market movement is losing momentum. It is at these times that a reversal is most likely. If we were considering a trade in the direction of the expected reversal, this would be an opportune time to initiate entry. On the other hand, when Momentum Confirmation occurs, we know that the current swing direction has some "oomph" left to it, and it would be best to either stay with the existing positions or look for an opportunity to climb on board.

When properly used, the 3/10 Oscillator can become a very helpful tool for the Active trader. It is a quick and effective means of measuring market momentum, revealing valuable information about the market's underlying intent. Become proficient in its use, but also realize that it is not infallible.

[Continue reading...](#)

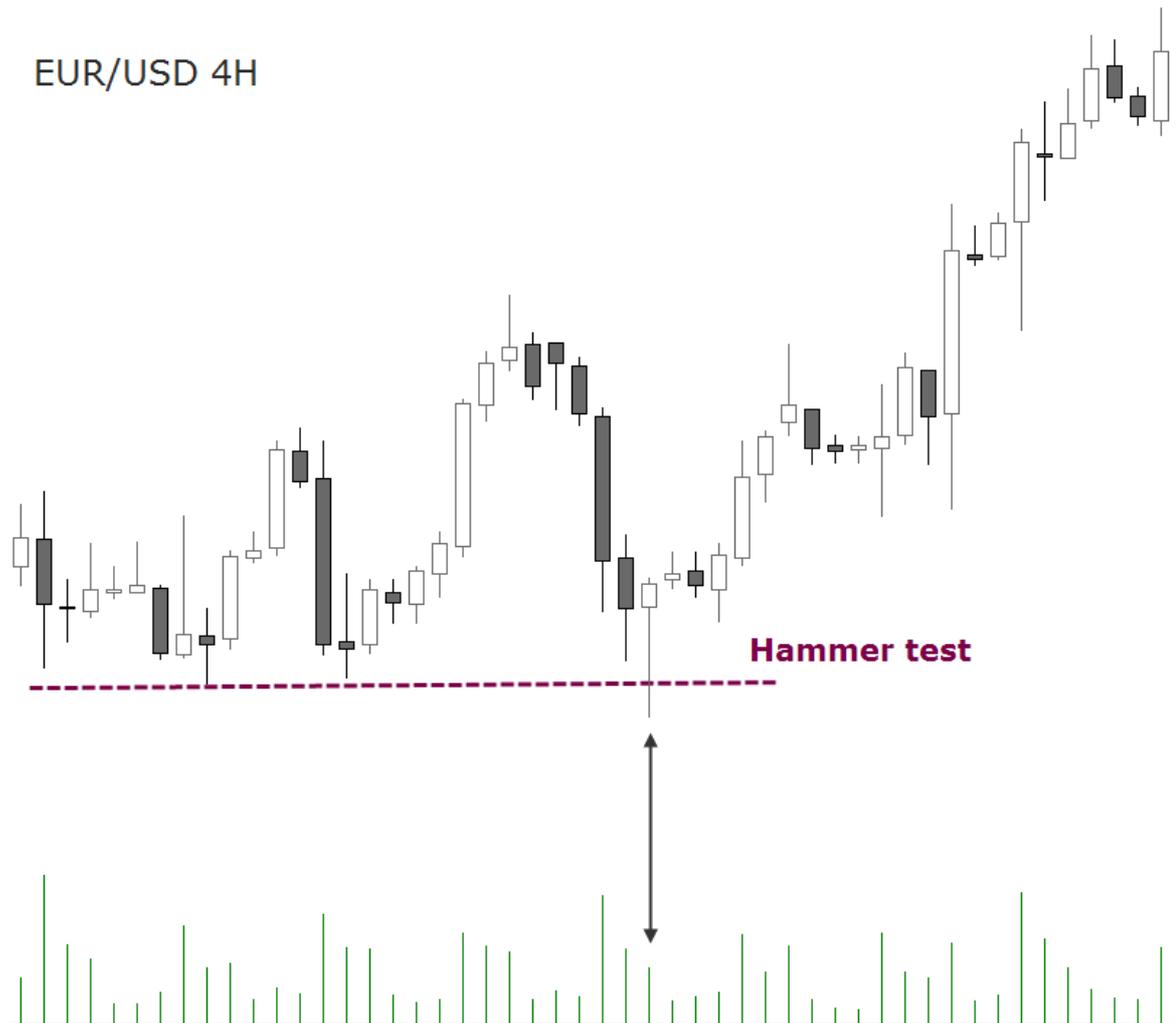
## Candlesticks and Wyckoff

There is another piece of knowledge you can add to your charting techniques for the enhanced clarity of market sentiment that it provides: the Wyckoff "Candle Volume Analysis", which Todd Krueger reveals in his article "Riding The Curves". Wyckoff made many important discoveries in the field of technical analysis. Specifically, he explained how the interrelationship between price and volume can add information to follow the footprints of the smart money. Its sheer trade volume sizes create imbalances in the supply/[demand](#) equation which are, says Krueger, the true cause of price movements.

“ In Wyckoff's trading days, he had no knowledge of this charting methodology or the enhanced clarity of market sentiment that it provides. The Wyckoff Candle Volume Analysis methodology greatly expands on Wyckoff's original work and further enhances the ability of the properly trained [chart](#) reader to identify the very supply/[demand](#) imbalances that the markets move from.

[Continue reading...](#)

The technique displays a combination of the **Wyckoff Volume Analysis** with candlesticks patterns ([Chapter B04](#)) by adding a volume histogram to the **chart**. Actual traded volume figures are not easy to obtain in the spot Forex markets. That is why a tick-based volume is used instead, which tracks the changes in price for a given time period. The reason we picked this strategy is because it examines the same phenomenon as the “bull or bear trap” mentioned above.



Do you see how the hammer’s lower shadow tests a **support level** by piercing it? This price action detects if more sellers will enter the market at lower levels below recent support. If there had been any latent supply, the exchange rate would have soared to new swing highs again. But since this test bar forms a near perfect hammer, in Wyckoff Candle Volume Analysis terminology it is called a “hammer test”.

The hammer test gives us two important signals: the first being a reduced volume

compared with previous candles, and the second is the information which a hammer usually transmits with the price piercing the **support level** and coming back to close above it. If this happens with a reduced volume, it shows that there are no large interests of potential sellers to take the exchange rate lower.



Volume in Forex is often Tick Volume: it is actually a count of “ticks” received in a time period; it is not contracts traded, or monetary volume, or even necessarily a change in the trading price. In the Metatrader charting platform used for the above illustration, any change in the trading conditions for the pair is counted as a tick. Such changes can be, for instance, a change in the spread (in the bid and ask prices), changes in the the swap conditions, changes in the tick size in [pips](#), or the [pip](#) value. For example, if you are trading EURJPY, and your deposit is in USD, then any change in USDJPY can adjust the “tick value” in EURJPY.

Source : [www.phytrade.com](http://www.phytrade.com)

## 4. Exit Strategies

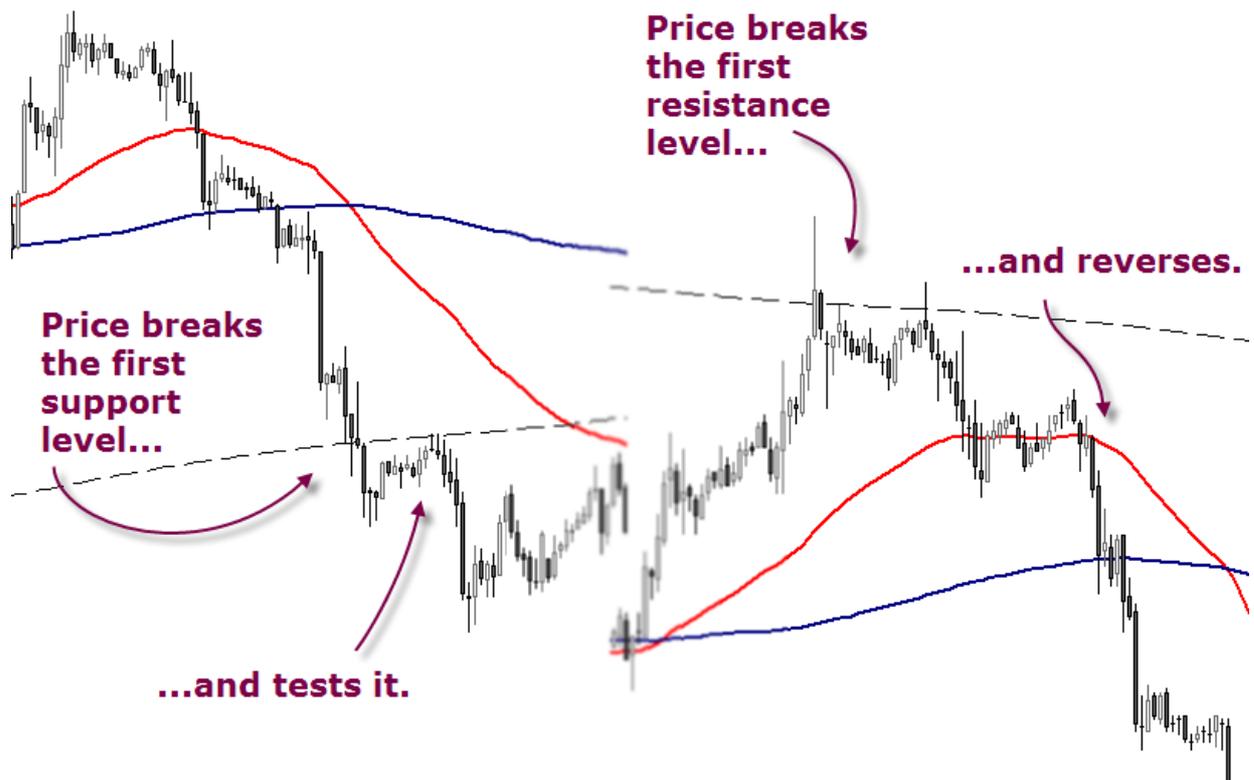
It is easy to get into the market, there are so many different techniques...but what about getting out? There is a vital difference between a trader who has an exact exit plan or none at all. It doesn't matter if the positions are in a profit or going down in flames, **as a trader you really need two exit strategies: one to handle profits and another to handle losses.** And when dealing with profits, you also need to know how to protect them.

Therefore, exit planning covers a stop-loss strategy to get out of bad trades, a profit-protection strategy to exit winning trades, and another strategy to save your neck in case of unexpected risks. You'll need all three tactics in every trade, because anything can happen once you hit the order button.

Andrei Pehar breaks the elements of a trading methodology down into 50% money management and 40% psychology. Guess how the remaining 10% is distributed? Pehar gives 8% to the exit techniques and the last 2% to entries. Stops, taking profits and managing the position makes up the 8%.

**Usually, when we think about a strategy or a trading system, we think in terms of entry criteria, whereas exits are the levels where you actually gain or lose money. This is one of the reasons so many people fail, not because they are bad analysts or have poor entry rules- it's because exit rules are almost nonexistent in their trading approaches.**

Novice traders usually start trading with a price-based exit strategy. They enter into a position, and, when it moves into profit, they exit the trade "blind" at the target price. This means they take the money and go, without considering the current price action. But what if there is still potential in the price movement? How do you protect the profits if you want to stay in the trade for longer? There are several ways to make a decision. The [chart](#) below outlines what may happen after opening a trade and the common stages it goes through:



The action/reaction may continue until the exchange rate hits your stop or it hits the final target. In this section, we want to focus on those elements which tell the trader when to move the stop in order to protect profits, or when to exit the trade entirely. Throughout the Learning Center we have seen some techniques, for example, on how to spot price action within shorter-term time frames ([Chapter B01](#)), or how moving the stop to breakeven can enhance your overall statistics ([Chapter C02](#)).

But you may find exit techniques like these too simple: “get out as soon as price breaks support on a long trade, or resistance on a short sale”. There are indeed at least two problems with them which **demand** further detail. First, many people lack the discipline to take losses when they should be taken; and second, you may not fully understand how to place stop losses.

Do you get frustrated because your stops get hit frequently on good trades? If the answer is yes, then probably the fault lies in your analytical skills and trade management, not in the stops themselves. Let's see some practical suggestions for stop placements based on technical tools.

## Managing the Position

Sunil Mangwani says that Pivot Points, unlike lagging indicators, are very effective from the risk point of view, since emerging stop levels are very clearly defined. He states:

“ For long positions, a trade is confirmed when price finds support on a pivot level. In this case, the pivot level below (the support pivot) acts as an effective **support level**. The probability of price dropping down to that level is very low; hence it becomes the safest technical level to place the stop.

[Continue reading...](#)

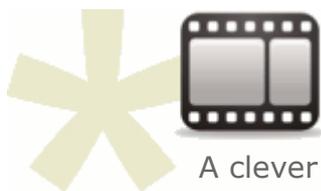


Indeed, Andrei Pehar, who also uses daily Pivot Points in his **intraday** trading approach, can sustain that view. [Discover with him one of the best kept secrets of bank traders](#). Pivot Points and their medians have long been a favorite of the biggest institutional players, and since they are the ones who move the markets, once you know the likely places for their pending **orders**, you also know the most likely levels for reversals. But too many traders calibrate their Pivots incorrectly since they lack an understanding of their meaning and how the markets work. In this webinar, fund manager and trading coach Andrei Pehar will take you inside the world of institutional trading and show you step-by-step how to set up and use Pivot Points.

Price has an uncanny way of respecting not only Pivot Points, but also Fibonacci ratios, often quite precisely. Traders in highly **liquid markets** such as the Forex use the Fibonacci ratios to ascertain the technical levels, which become effective stop levels to manage an open position.

**A powerful combination is the result of Fibonacci levels AND Pivot Points.**

Professional traders pay special attention when these two indicators are confluent and the exchange rate snaps to these levels in a clear manner. Did you attend the amazing speech by James Chen on confluences during the [ITC 2009](#)?



A clever way on how to anchor the Fibonacci ratios and improve your position management with this tool was given to us by [Andrei Pehar in an exclusive interview](#) recorded at the FXstreet.com's International Traders Conference 2009 in Barcelona.

Related to the same topic, we also find Joe DiNapoli's assumption that some Fibonacci levels are more effective than others to determine future price action. While it's true that prices does not express themselves in the same exact, mechanical manner each time they react to a Fibonacci level, this tool is capable of providing us with the ability to make price forecasts characterized with an improved probability of outcome.

In an effort to simplify the Fibonacci retracement and expansion ratios, Joe DiNapoli only uses the 0,618, 1,0 and 1,618 ratios and ignores all the other numbers derived from the series.



I use three simple equations to establish logical profit objectives, where A, B and C (Figure I) are specific points in a market move. The first objective is the 'contracted objective point' (COP). It utilizes the Fibonacci ratio 0.618:

$$\mathbf{COP = 0.618 (B - A) + C}$$

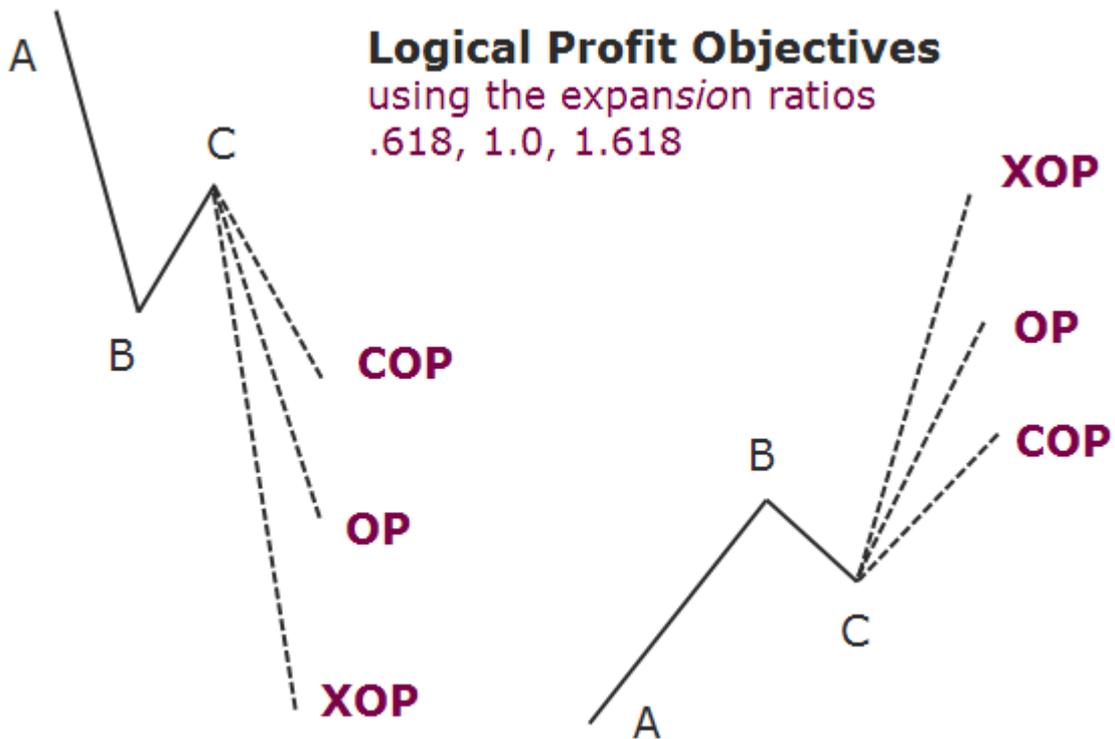
The second objective is the 'objective point' (OP), which uses the Fibonacci ratio 1.0:

$$\mathbf{OP = B - A + C}$$

The third objective is the 'expanded objective point' (XOP), which uses the Fibonacci ratio 1.618:

$$\mathbf{XOP = 1.618 (B - A) + C}$$

[Continue reading...](#)



The author suggests to calculate these “logical profit objectives” from any ABC market swing, whether the thrust is up or down. You might choose to take all your profits at one target level, or you could “peel off” the position size at each target. He proceeds by explaining:

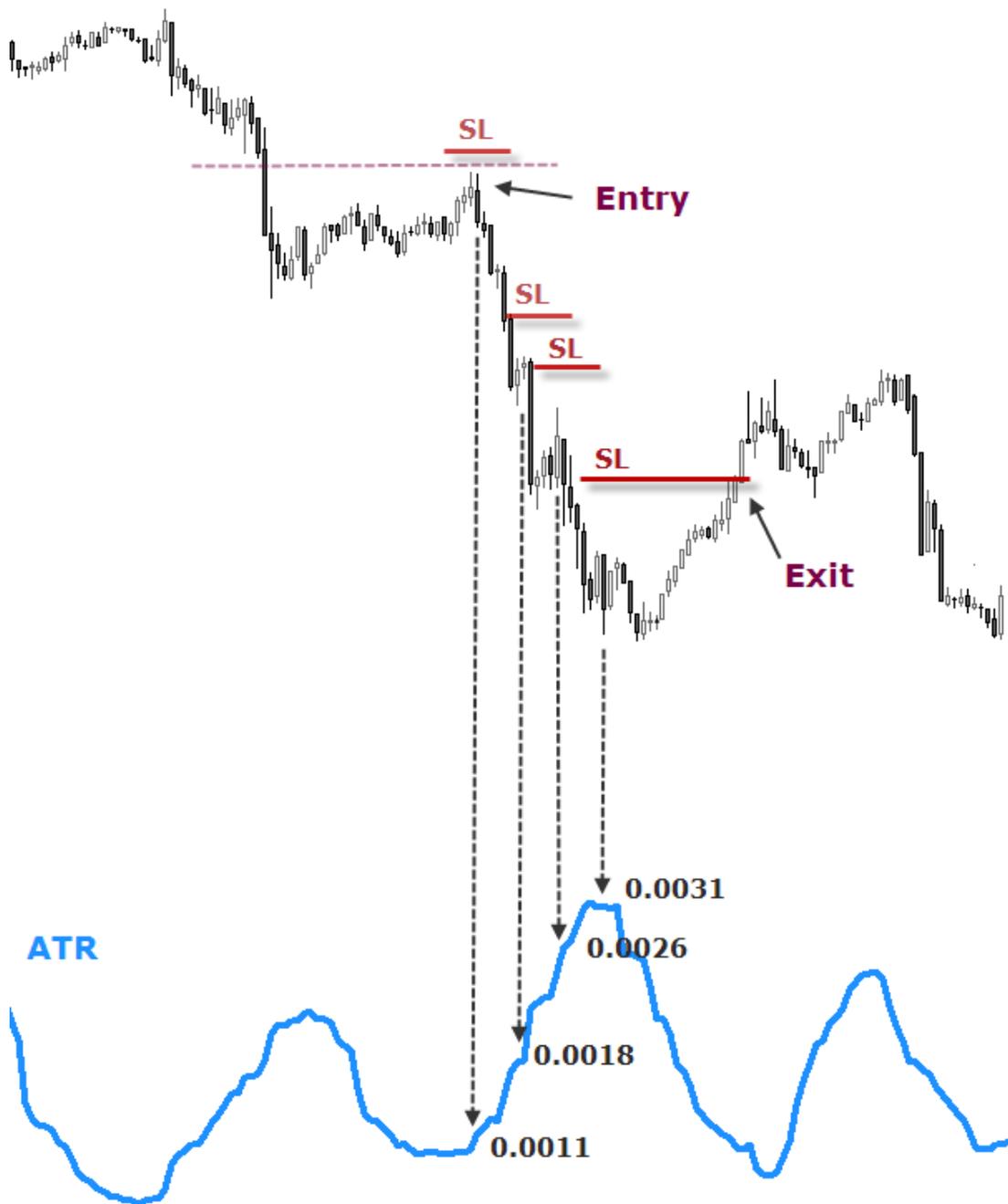
“ It is possible for the move that occurs after the wave ABC to reach all three objective points after experiencing a reaction at the previous profit objective. It is also possible that the first objective could be the end of the move. Note that, when using logical profit objectives, significant selling will be manifest at all three objective points in an up move, while buying will occur in a down move. You cannot be sure of the extent of the resulting reaction, only that the activity will occur. There’s nothing wrong with exiting partial positions at each objective as it is met.

## ATR For Trade Management

Stops and targets can also be managed with the Average True Range indicator if you

prefer to **set stops, trail stops, or set objectives based upon volatility**. You can even use this tool to assist you in position sizing.

The below **chart** displays a short entry with a ATR value of 0,0011. The stop is thus placed 11 **piPs** above the high of the entry candle and the target another (11) **piPs** below the entry price. If the exchange rate reaches the target, you can liquidate your entire position or close it partially. The remaining **lots** can be trailed by at ATR value above the most recent swing high.



As for the position sizing, Joe Ross explains:

“ Let’s say we are willing to risk \$1000 on any one trade, and that \$1500 is 1.5 per cent of our trading account. We look at our [chart](#) (see figure 1). In this case, using a 7-bar ATR, we find the most recent high value for ATR is 0.028. If we want to get long at 1.3296, we will place a loss-protecting order at 1.3016 ( $1.3296 - 0.028 = 1.3016$ ), which amounts to \$280. That means we can trade five [lots](#) and stay within our \$1500 risk amount. But what do we do if the ATR number is too high? For example, what if the ATR was 0.0418? Assuming the same entry at 1.3296, subtracting 0.0418 would cause us to have to place our loss protection at 1.2878. Can we safely handle a \$418 loss? We can if we lower our position size to three [lots](#). What we can learn here is that if the ATR, which is an expression of volatility, becomes too great for our risk tolerance, we can opt to pass on a trade in this market. Or we can drop down to a shorter time and trade there. A shorter time will give us a lower ATR number.

[Continue reading...](#)

## Channel Exits

Another method of trailing the stop is commonly referred to as a “Channel Exit”. Quoting Charles LeBeau in one of his articles for the *Trader's Journal*, we can read:

“ The 'channel' name comes from the appearance of a channel formed from using the highest high of x bars and the lowest low of x bars for short and long exits respectively. The name also derives from the popular entry strategy that uses these same points to enter trades on breakouts.

[...]

A channel exit is extremely versatile and can work equally well with weekly bars or five-minute bars. Also, keep in mind that any examples referring to long trades can be equally applicable to short trades.

[...]

The implementation of a channel exit is very simple. Suppose we have decided to use a 20-day channel exit for a long trade. For each day in the trade, we would determine the lowest low price of the last 20 days and place our exit

stop at that point. Many traders may place their stops a few points nearer or further than the actual low price depending on their preference. As prices move in the direction of the trade, the lowest price of the last twenty days continually moves up, thus “trailing” under the trade and serving to protect some of the profits that have accumulated. It is important to note that the channel stop moves only in the direction of the trade. When prices fall back

through the lowest low price of the last twenty days, the trade is exited using a sell stop order.

[Continue reading...](#)

A longer channel length will usually work better in a long-term **trend**-following strategy, while a shorter channel will usually capture more profits in smaller **trends**. LeBleau suggests, among other variants, a trailing exit set at the lowest low or the highest high of the last 20 days or more for long term **trend** following strategies, between 5 to 20 days for intermediate term strategies, and between 1 to 5 days for short term strategies. But we recommend to test these parameters with your preferred currency pairs before adopting this exit mechanism.

**The advantage of setting stops using a technical formula, is one way to move your stops away from the clusters where the majority of market participants set their stops at. This way, you can achieve better executions on your exits and lower the probability of a stop run.**

The method of taking those profits which are on the table works best when you are trading counter **trend** since the anticipated amount of profits is relatively limited. We have seen it, for example, in Toni Juste's Money management model ([Chapter C03](#)) and also in [Andrei Pehar's Institutional Trading Strategies](#) series. However, to take quick profits in a **trend** is usually frustrating when we see the price continue to move in our trade direction without us. Therefore, we recommend exploring different profit taking strategies to get the most out of each trade's profit potential.



More comprehensive studies of trading strategies are provided in the [Trading Strategy](#) section, which is constantly updated through regular add-ons like Raghee Horner's Waves, Phill Newton's bias change rules and Andrei Pehar's use of the ADX, just to mention a few. We encourage you to explore the transcripts areas of the Live section as well if you are seeking more information.

We hope you enjoyed this chapter. One remark of interest should you still be trying to fit the puzzle pieces of your trading system together: think that those who have the most toys will not win, but rather those who have the most knowledge and can change their behavior.



Feel free to comment on your strategies at the [LC Forum](#).



What you have learned from this chapter:

- Thinking in terms of concepts can help you achieve the edge required in your pursuit of long-term consistent success.
- Markets inhale and exhale as dynamic [trends](#) evolve. There are strategies for all the phases.
- The most robust and versatile systems are build on several strategies.
- The very same concept or hypothesis can be capitalized on using different indicators.



FXstreet.com contents:

- [Finding Your Entry](#), by Andrei Peihar
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- [If you can't spot it, don't trade it](#), by The Trader's Journal Collaborators
- [Five Steps to Consistent profits](#), by The Trader's Journal Collaborators
- [Introduction and Oscillator Divergence/Momentum Confirmation](#), by Bob Hunt
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- [Ichimoku Trading: Strategies, Setups and What to Watch for](#), by Chris Capre

External links:

- [Forex Volume on Metatrader](#), by phytrade.com

Books:

- "FOREX Patterns and Probabilities", Ed Ponsi, Wiley Trading, 2007