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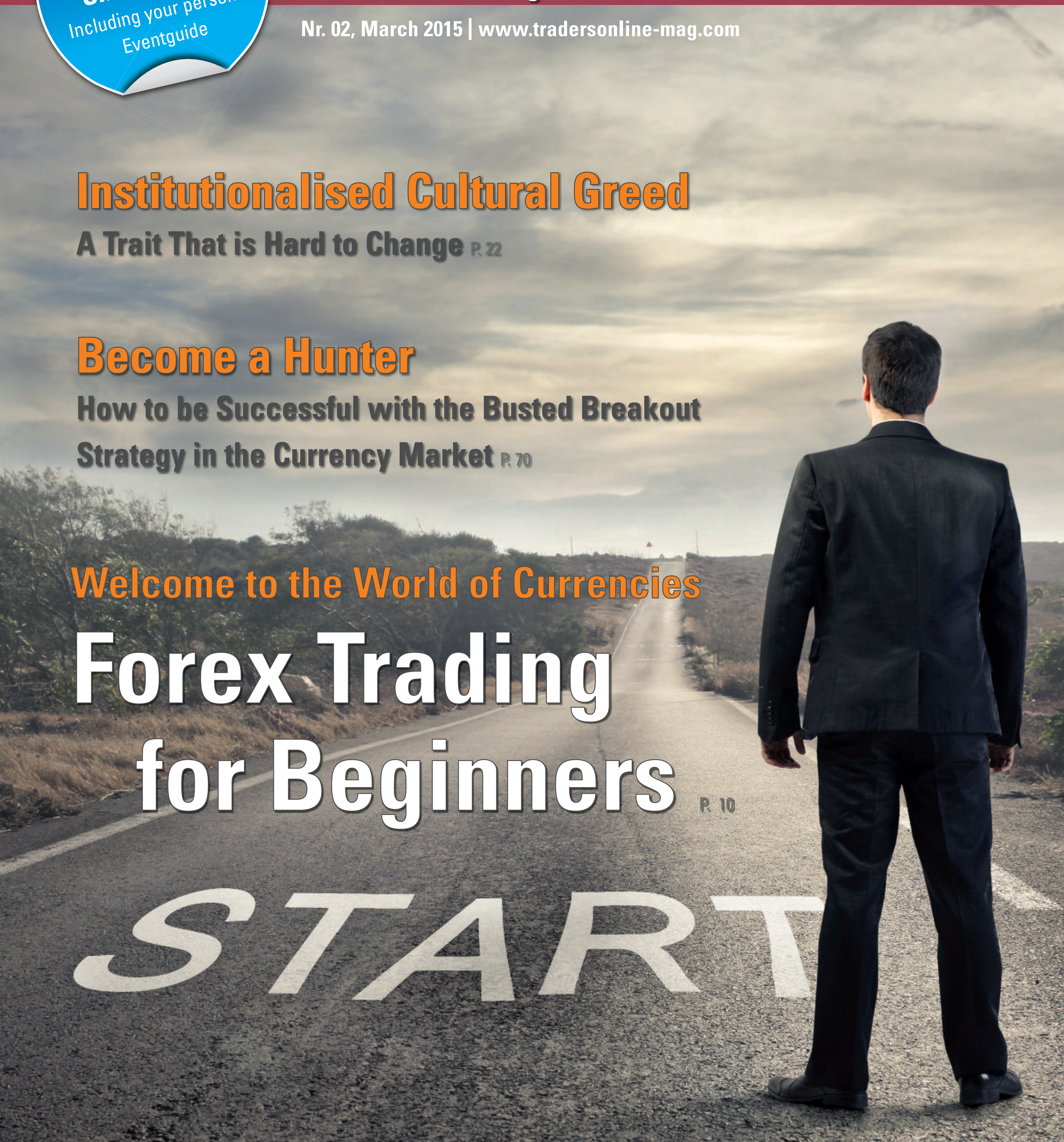
Nr. 02, March 2015 | www.tradersonline-mag.com



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Become a Hunter

How to be Successful with the Busted Breakout Strategy in the Currency Market

Your stop has been hit – again? You should become the hunter fishing for other peoples' stops by profiting from the trader-trap. Enter the trade when others have to exit and watch how others are caught on the wrong foot – this time to your advantage!

» Psychological Traces in the Market

The search for low-risk trading ideas has always been the most important task for traders and investors. That hasn't changed much. The main goal is to find situations where rewards exceed risks considerably.

It is still a major advantage, if you are able to read and use explicit, recurring and profitable patterns in the market. At certain points in the chart, when buyers and sellers stalk each other for quite some time, tension builds-up and the result is typically a strong momentum move. These situations leave a clear trace in the market (visually as well as psychologically) and therefore they can be used to trade profitably.

Goal of the Strategy

The Busted Breakout Strategy is based on a specific consolidation pattern in the forex chart and profits from false breakouts within the overall trend. The so-called trader-trap is one of the most important aspects in addition to other advantages. The trap develops because of counter-trend traders, often inexperienced traders with a big ego who trade against the market. They try to trade breakouts against the trend direction. Very often these situations look as an "easy gain", however once entered they tend to reverse in a sudden taking everybody by surprise. This situation, called the trader-trap, causes painful losses for many market participants. The market does not teach one thing for nothing – humility.

According to the strategy, you should enter a trade early on at the first signs of a fake breakout with a tight stop-loss to profit from the panic that will follow. Typically due to the dilemma in the market, impulsive movements start to develop in trend direction that are further reinforced by the running for stops. The goal is to bring your own position into profit as soon as possible with this first impulsive movement move. After that first move you can then profit from the overall swing-move as the continuation of the overall trend.

A previous consolidation pattern in the trend development is important, because many countertrend traders (ideally in different time frames) have to be "convinced" that the existing trend is over now and a counter movement is about to start soon. It is important to consider the higher time frame – compared to the entry chart – to ensure the reliability of the strategy. The average win rate is 65 per cent. A clearly defined entry and a tight stop-loss are further advantages of this strategy.

The Setup

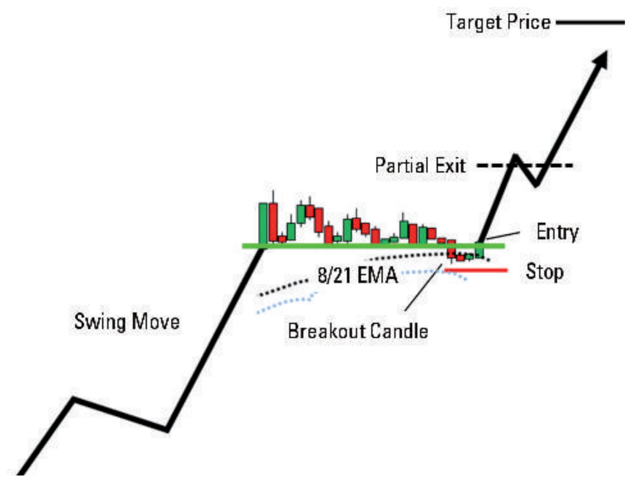
The trade setup consists of three phases: (I) build-up of pressure in the trend, (II) the trader-trap as well as (III) the stop-fishing and trend continuation. In this strategy it is important to analyse the entry chart as well as the higher time frame (HT). Typically the higher time frame is defined as four to six times higher than the entry chart. For example: for the 15-minute time frame – the higher time frame is the 60-minute chart.

The first two phases determine the setup. The rules for the long-entry are as follows (short entry vice versa):

(I) Build-up of Pressure in the Trend:

a. Higher time frame (HT): exponential moving averages (EMAs) in correct order, which means 8EMA>21EMA>50EMA. This needs to apply for the last 15 candles in the HT.

F1) Busted Breakout Scheme (Long Entry)



The entry (long) is prepared by the breakout candle and occurs with the re-break of the green breakout-line. The stop is placed below the breakout attempt. The profit target – which is a 100 per cent projection of the swing move – has to have a RRR of at least 3.

Source: Gabriel Grammatidis

b. Impulse movement before consolidation: span of impulse at least 6xATR(14) (ATR = Average True Range) based on the start until the end of the swing move.

c. Consolidation: consolidation pattern on a horizontal line with at least five touches (ideally lower highs form)

(II) Trader Trap:

a. Higher time frame (HT): price in HT within the exponential moving average band (8/21 EMA)

b. Breakout: breakout-candle with close below the horizontal line of the consolidation. Clear and dynamic breakouts with little follow-through are the best.

c. Re-break: After the breakout-candle has formed the price needs to move back above the horizontal line. The re-break can occur directly after the breakout-candle or a few candles thereafter.

The entry is performed directly at the re-break above the horizontal breakout-line that confirms the trader-trap. You place the stop in the market at the same time as the entry. The stop is placed a bit below the low of the breakout-attempt.

The profit target is calculated based on a 100 per cent projection of the previous swing-move and is placed at the breakout-low. After the entry we expect a movement about the same size as before the busted-breakout-pattern. The reward-risk-ratio (RRR) must be larger than 3. Due to the tight stop this is usually fulfilled in most cases (see Figure 1). We exit part of the position after the stop-runs have occurred, or alternatively, after reaching a book profit of 1.2-times the trade-risk (1.2R). After closing out a fourth of the position and placing the stop below the breakout-line the position is break-even. At that level the stop is still well protected. About 20 per cent of the time the breakout-level is retested. We trail the stop for the remaining position at 25 per cent profit every time a new high is reached until the profit target or the stop is hit.

Beliefs as Strong Basis

Robust trading systems that generate stable profits in the long term are based on a strong fundament of beliefs. You can only be profitable with this system, if you agree and identify yourself with the following beliefs:

- Market trends usually continue longer than the market participants can ever imagine.
- Price-consolidations within a trend represent a period of pause (or short refreshers). They are necessary for the trend to gain strength again before it is able to continue.

- Market participants leave "psychological footprints" in the chart that can be recognized as specific visual patterns. An understanding of the underlying emotional dynamic represents a great advantage in the market.
- The "crowd" in the financial markets is wrong most of the time and, therefore, loses.
- Traders with big egos have difficulties to be successful.
- The strongest and most reliable movements develop, if market participants are caught in a dilemma (trader-trap).

Real Examples

The example in Figure 2 (GBP/USD, long) shows very well that there is a clear consolidation within the trend development on a horizontal line with seven touches (see light green line numbered from 1 to 7). On 1st July 2014, between 3 p.m. and 6 a.m. the following day, sellers and buyers stalked each other very closely. During that time the build-up of pressure occurs that is important for the continuation of the trend. Because of the length of the consolidation (15 hours) more and more market participants got notice of this situation. The longer the consolidation takes, counter-trend traders became more and more convinced that an entry short after the breakout will be successful. The tension grew (see several small candles near the line) and a decision – in either way – was about to be made. There were several breakout attempts below the green line. The re-break confirmed the trader-trap and led to the entry into the long-position (1.7102). The stop (1.7093) being well protected is below the horizontal green line, the relevant big number 1.7000, as well as, the low of the breakout-attempt. The profit target (1.7162) equals a RRR of 5.3.

How can you read this situation regarding the "psychological footprint"? The counter-trend traders opened their short-position with the dynamic breakout-candle. Whereas some stops were placed directly behind the line, others were put at the various highs of the consolidation. The positions showed first signs of weakness because the price broke the strong resistance of the breakout-line to the upside (re-break). The tension increased creating the necessary emotional pressure (trap-in). The countertrend-traders become caught up in a state of shock. The stops that are put in the market in a cascading manner are no longer in far distance and act like a magnet.

Furthermore there is a second group of market participants that can be caught in the same trap: Buyers, who were running their long-position for quite some time making good profits. They fear losing part of their profits and, therefore, there is the tendency to protect their profits too tight. The stop is placed, on an allegedly safe level, just below the horizontal line. As a result the stop is hit with the breakout-movement down that creates a trap-out. Due the continuation of the upwards trend, the trader fears a losing opportunity. He needs to re-enter which is the reason for an additional increase in prices.

You can see clearly the stop-fishing of all stops with a strong impulse movement that reaches above the highs of the consolidation (long green candle). We exit part of the position at 1.5-times the risk at 1.7120 and place the

Gabriel Grammatidis

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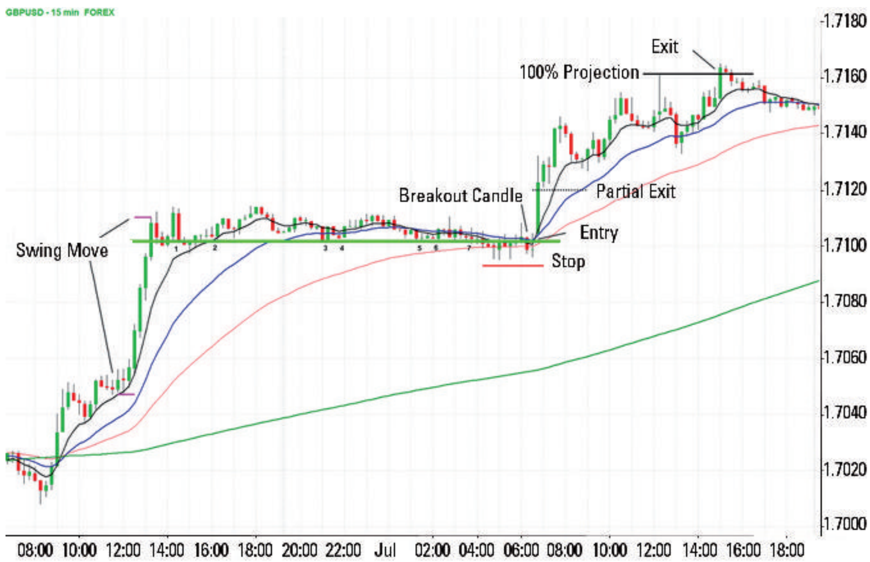
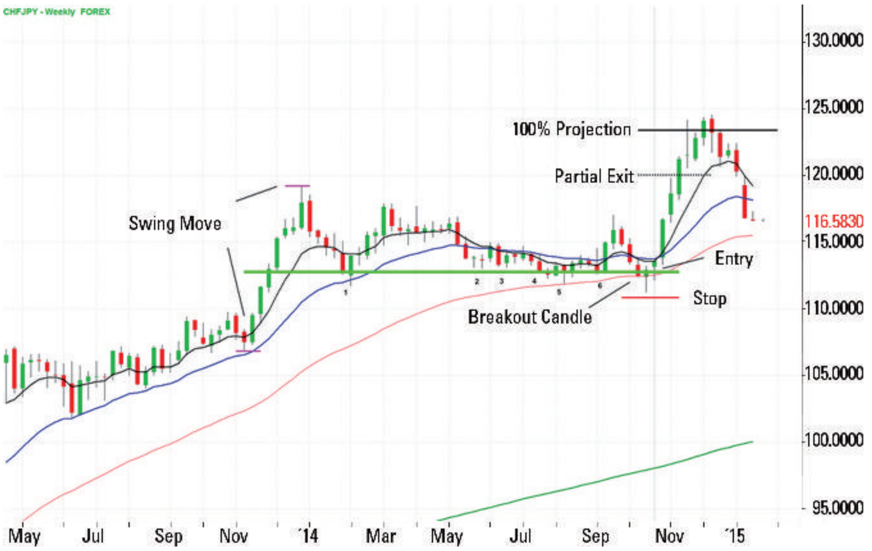
F2) GBP/USD Spot, Long (15-Minute Chart)



A long consolidation within the uptrend built the necessary pressure. The trader trap gets closed after the countertrend traders were tempted into the market. The failed breakout attempt to the downside completed the setup. What follows is a strong impulse movement (stop-fishing).

Source: TradeStation

F3) CHF/JPY Spot, Long (Weekly Chart)



The breakout-attempt short was dynamic, however without much follow-through – a clear hint for the trader trap (Trap-In). The running for stops takes place in a dynamic way. The price movement after the entry is nearly identical to the previous swing move regarding the size and impulse strength.

Source: TradeStation

stop below the breakout-line. This puts the trade into break-even. The profit target (100 per cent-projection) is reached a few hours later and the trade is closed at 1.7162 with a profit of 4.3-times the risk.

Another example is the CHF/JPY currency pair in the weekly chart (Figure 3). The impulse movement (swing move) as well as the consolidation are similar to the one in the previous example. The requirements of the setup for the higher time frame – the monthly chart – are fulfilled; the same goes for the impulse-span of the previous swing-move, which is more than 8ATR. The entry (113.02) and the stop (110.80) are executed and placed after a clearly failed, dynamic breakout-attempt below the green line. The candle following the breakout-candle shows the relevance and strength of the horizontal line. The RRR is 4.7 and we exit part of the position at 120.00 (+3.1-times the risk) after the stops have been fished at the level of the highs of the consolidation. The profit target at 123.26 is reached quickly and the trade is closed with 4.4-times the initial risk.

Strategy Snapshot

Strategy Name:	Busted Breakout Strategy
Strategy Type:	Swing trading with the trend
Time Frame:	All time frames
Setup:	Ia/b/c: overall tend (HT), impulse movement and consolidation; IIa/b/c: price within band (HT), breakout-candle and re-break
Entry:	At re-break of the horizontal breakout-line
Stop-Loss:	Below the failed breakout-low
Take Profit:	1st exit of part of the position (1/4 of the position) after stop-fishing (exceeding the consolidation high); 2nd exit at profit target (100%-projection)
Risk and Money Management:	0.5-1.5 % risk per trade
Average Number of Signals:	About 500 per year (based on 20 currency pairs)
Average Hit Rate:	65%
Average Yield per Trade:	+0.6 times the risk

Practical Implementation

The strategy was originally developed for the forex market. However it works equally well in liquid and deep markets like indices, bonds and commodities. Due to the fractal nature of the markets all time frames – from tick- to weekly chart – can be traded. The strategy applies to both discretionary and automated trading system.

It takes some practice to identify the visual patterns in the market. If you trade fully automated, you have to concretise the rules further to duplicate the intuitive component of the pattern recognition. A big advantage of the forex market is the 24-hour-trading. The strategy works well during all trading times.

Be aware that the setup and the entry are just one part of a trading strategy. A differentiated exit-algorithm, a dynamic position-sizing, the definition of the market typology, as well as, a clearly defined risk management are further important system components.

Conclusion

It is important that you agree with the beliefs of the system to trade it profitably. The difficulty of the strategy is that you have to trade against the common sense of the trading crowd.

The entry often seems counter-intuitive – so do not let you get disturbed by this! Because that is the reason why the strategy works so well. It is definitely more fun to profit from other peoples' stops than to be stopped out with a sudden loss. Which group do you want to be part of? «