Example 6.4: Long Trade in the Currency Pairs Using Kumo Break Strategy

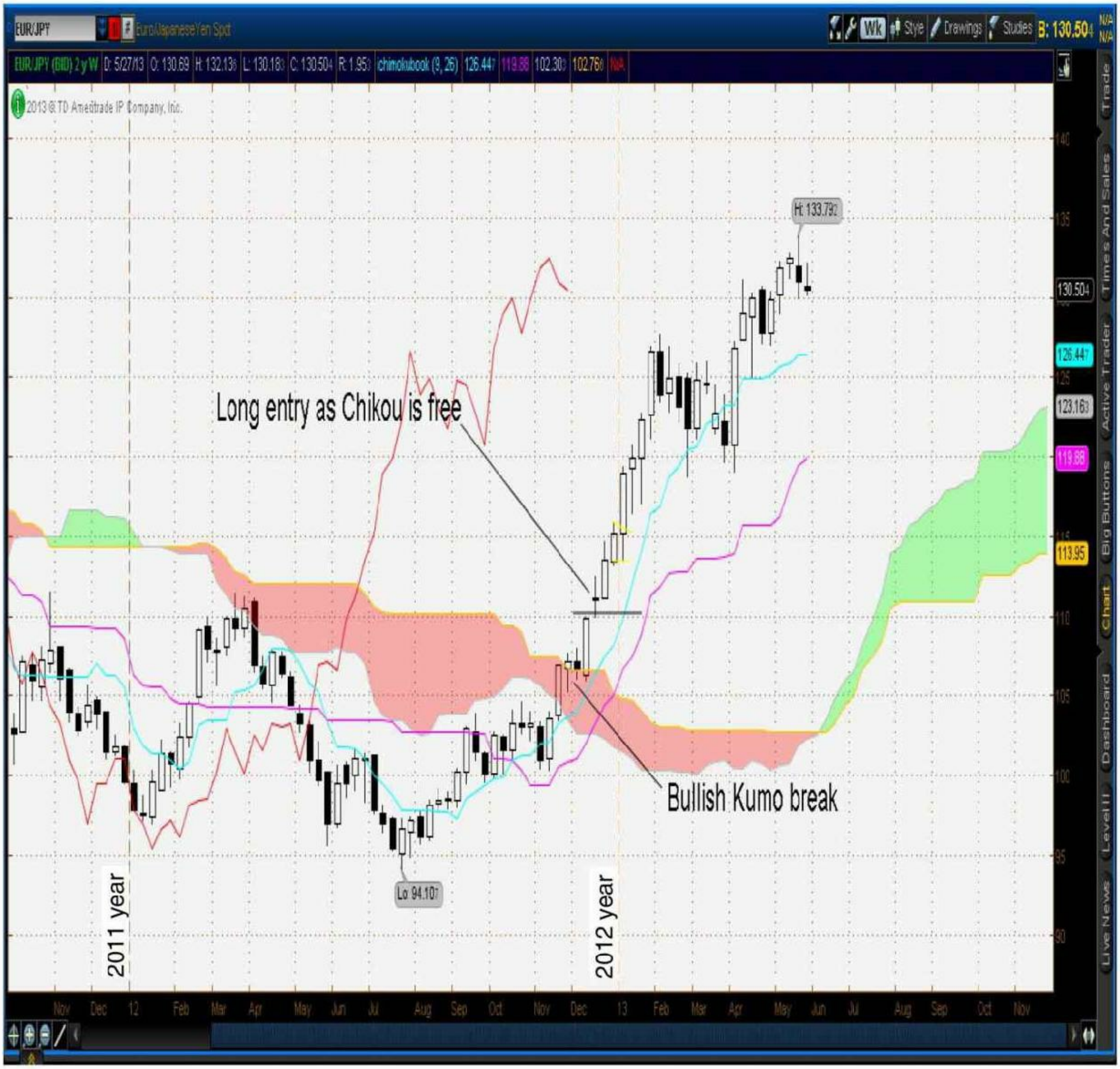

Figure 6.4: **Weekly chart for long trade in currency pairs — note the entry and bullish Kumo break points**

Trade Set-up for Long Entry in the Week of 17 December

Tenkan / Kijun: As you would note in the weekly chart in Figure 6.4, the price on 17 December is above both Tenkan and Kijun which is a bullish sign. Tenkan is above the Kijun, which is also bullish. Both Tenkan and Kijun will continue to rise as the price goes up, offering it support.

Chikou: At the point of entry, the Chikou will be clear of any price interaction. This should help the price moving up without much resistance coming in.

Current Kumo: Price is above current Kumo.

Future Kumo: The future Kumo is bullish, confirming all the other indicators.

Initial Stop: The initial stop will be below the Kijun. This stop can be raised as the price starts to move higher and draws the Kijun up with it.

Trade Analysis

Figure 6.4 shows a weekly chart for the Euro / Yen currency pair. You would notice that the bullish Kumo break occurred the week of November 26. However, the future Kumo was still bearish at this point. The Chikou was free of price congestion from 26 weeks ago. In the next couple of weeks, the future Senkou A crossed Senkou B to give the bullish Kumo twist. Keep in mind that since this is a weekly chart, trades will last much longer and could potentially yield huge profits like in this case.

Partial profits should be taken along the way as the price moves up and the final remaining position should be stopped out below the Kijun.

Example 6.5: Long and Short Trades in Australian Dollar Futures Using the Kumo Break Strategy

Figure 6.5: **Buying long — and short selling — Australian dollar futures — the Kumo breaks and entry points are indicated on the chart**

In this case, we will look at two possible trades using the Ichimoku system.

Trade Set-up for Long Entry on 9 April

Tenkan / Kijun: For the long entry, the price is above the Tenkan and Kijun, which is a bullish sign. Tenkan is above the Kijun, which is also bullish. Moreover, both Tenkan and Kijun will continue to rise as the futures price goes up, thus offering support to the price.

Chikou: At the point of entry, the Chikou will be clear of any price interaction.

Current Kumo: The current Kumo is bearish.

Future Kumo: The future Kumo is bullish, confirming all the other indicators.

Initial Stop: The initial stop will be below the Kijun. This stop can be moved up as the price starts to move higher and draw the Kijun up.

Trade Analysis

As can be seen in the chart in Figure 6.5, a bullish T/K cross occurred in the Australian Dollar futures on 15 March. However, the Chikou was then below price from 26 days ago. After a couple of weeks, the futures price closed above the Kumo. Notice how the price pulled back to the flat Kumo, finding support on the Tenkan and the bottom of the Kumo itself. On 5 April, the future Kumo turned bullish setting up for a long entry above the 9-period high as highlighted on the chart, which was also the 26-period high. This ensured that both Tenkan and Kijun would be pulled up upon trade execution.

The trade would have resulted in a small loss as price fell through the Kijun four days later. Remember, keep the losses small and let the profits run.

Trade Set-Up for Short Entry on 7 May

Tenkan / Kijun: As can be seen in the chart in Figure 6.5, the price is below the Tenkan and Kijun, which is a bearish sign. Tenkan is below the Kijun, which is also bearish. The Tenkan and Kijun will both continue to fall as the price heads lower, offering resistance to the stock.

Chikou: At the point of entry, the Chikou will be clear of any price interaction.

Current Kumo: The current Kumo is bearish.

Future Kumo: The future Kumo is also bearish, confirming all the other indicators.

Initial Stop: The initial stop will be above the Kijun. This stop can be moved down as the price starts to move lower and draws the Kijun down with it

Trade Analysis

Price closed below the Kumo on 23 April. At this time, however, the future Kumo was still bullish. On 29 April, Senkou A crossed below Senkou B to form the bearish Kumo twist. Placing a sell order below the 9-period low would ensure that the Chikou would be in open territory. The sell order point is indicated on the chart in Figure 6.5.

Profits should be taken as the price moves down and the final remaining position should be stopped out when price closes below the Kijun.

Example 6.6: Going Long in Citibank Using the Kumo Break Strategy

Figure 6.6: **Going long in Citibank on NYSE — the bullish Kumo break and the final stop out are highlighted on the chart**

Trade Set-up for Long Entry on 21 August

Tenkan / Kijun: In Figure 6.6, the price is above both Tenkan and Kijun, which is bullish. Tenkan is above the Kijun, which is also bullish. The Tenkan and Kijun will both continue to rise as the stock goes up, offering support to the stock.

Chikou: At the point of entry, the Chikou will be clear of any price interaction.

Current Kumo: The current Kumo is bearish.

Future Kumo: The future Kumo is bullish, thus confirming all the other indicators.

Initial Stop: The initial stop will be below the Kijun. This stop can be moved up as the price starts to rise higher and draws the Kijun up with it.

Trade Analysis

As indicated on the chart in Figure 6.6, a bullish Kumo break occurred in Citigroup on 20 August. All the Ichimoku components were then lined up for a long entry over the 9-period high. The stock pulled back some but reversed soon as buyers stepped in. Notice how the Kijun kept moving up throughout the trade as the 26-period lows kept getting higher and the stock kept making new 26-period highs.

Profits should continuously be taken as the price moves up and the remaining position should finally be exited when the price gives below the Kijun.

Example 6.7: Shorting 10-year US Treasury Notes

Figure 6.7: **10-year US Treasury notes provide shorting opportunity on 4-hour chart — the bearish T/K cross and the short entry point are indicated on the chart**

Trade Set-Up for Short Entry on 22 May

Tenkan / Kijun: In Figure 6.7, the price is below both Tenkan and Kijun, which is a bearish sign. Tenkan is below the Kijun, which is also bearish. Also, both Tenkan and Kijun will continue to fall as the price heads lower, thus offering resistance to the price.

Chikou: At the point of entry, the Chikou will be clear of any price interaction.

Current Kumo: The current Kumo is bearish.

Future Kumo: The future Kumo is also bearish, confirming all the other indicators.

Initial Stop: The initial stop should be placed above the Kijun. This stop can be moved down as the price starts to move lower and draws the Kijun down with it.

Trade Analysis

Figure 6.7 shows a 4-hour timeframe chart for the 10-year US Treasury Notes. You can see the strong bearish T/K cross that happened with the 5.00 p.m. candle on 20 May. At this point, the Chikou was still in the price congestion from 26 periods ago. It broke free to the downside with the 9.00 a.m. candle on 22 May. Setting a sell order below the low of this candle would have triggered the trade on the 5.00 p.m. candle on the same day. The price rallied back up but failed to close above the Kijun. Notice how many candles bumped against the flat Kijun and were rejected.

Profits should continuously be taken as the price moves down and the final remaining position be stopped out when the price closes below the Kijun.

7

Ichimoku Trading Tips

Avoid Entering a Trade Before Earnings Announcements

Fundamental news, such as an earnings announcement, can render technical analysis irrelevant. Investor sentiment can change overnight from bullish to extreme bearish, or from bearish to overly bullish. This does not bode well for someone using charts to make trading decisions. The bullishness of a chart can be instantly negated as price succumbs to investor fear and greed in a moment of panic or euphoria, respectively. The consequences can be disastrous for the portfolio if the price gaps heavily against you. There could also be an occasional surprise announcement which will have the same effect. However, those are the unknowns a trader has to face. Earnings announcements, on the other hand, are known well in advance. The trader can liquidate the position a day before such an earnings announcement and use the capital for another high probability trade. To illustrate, and to emphasize, this point look at the chart of Infosys Ltd. in Figure 7.1.

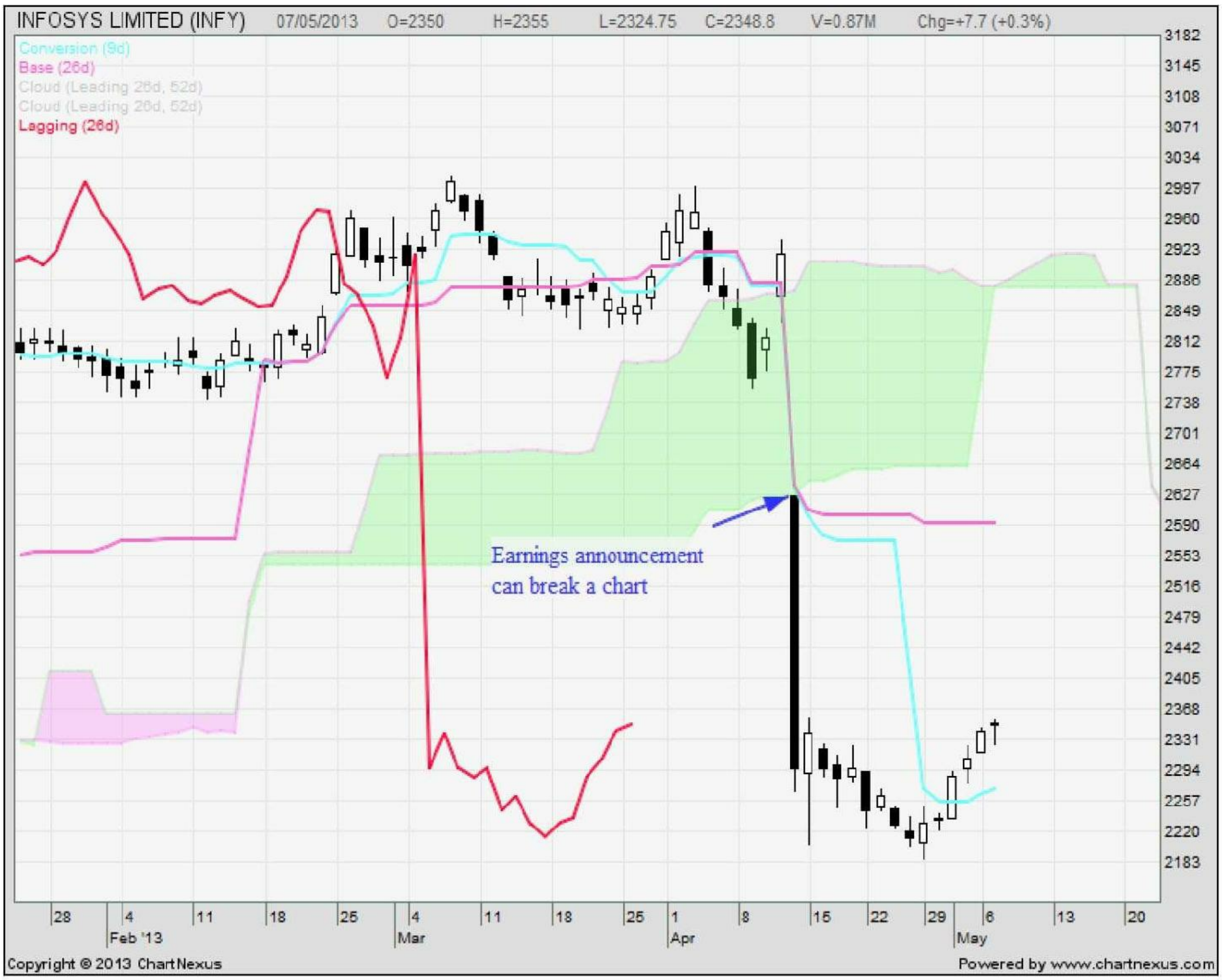

Figure 7.1: **The chart of Infosys shows how fundamental news can negate a good trade set-up**

No technical system can withstand a fundamental shock. So, it's best to avoid trading in stocks with known upcoming fundamental events.

Avoid Trading Low Volume Stocks

The main reason why technical analysis works is because markets (traders) have memory. The greater the number of traders in a stock, the stronger the memory. And a strong memory contributes to better repeatability of patterns. Even in Western technical analysis, memory is what makes patterns, such as the double bottom or ascending / descending triangles, work. Recall the use of Chikou in our case. Why do we need to see the Chikou clear of price congestion? (Refer to Chapter 2 for explanation.)

It stands to reason that having low trading volume means less memory. This means when you expect the price to behave in a certain way at key levels, there is good chance it will not. As a technical trader, this is not what you want. Repeatability is crucial in trading. If I expect the price to find support on a flat Kijun in a trend, the price needs to do just that. If the price is all over the place disregarding the Kijun, trading will be more of gambling. As the chart in Figure 7.2 highlights, low volume charts are notorious for such behavior.

Figure 7.2: **The haphazard movement of price in the chart of Alicon Castalloy Ltd. shows why you should avoid trades based on low volume charts**

Timing Entries After Pullbacks in a Trend

Traders can enter a trending stock even after they miss, say, the initial T/K cross or the Kumo breakout entry. We know that prices use the Tenkan and Kijun as support in a bullish trend. Conversely, prices use the Tenkan and Kijun as resistance in a downtrend. A strategy can be formed using this knowledge.

Strategy in a Bullish Trend

Wait for a pullback of the stock below the Tenkan. It will probably test the Kijun for support. If it finds support, there is a good chance of the price continuing in the uptrend. If this happens, and price closes back above the Tenkan, place a buy order above the 9-period high — the 26-period high if it's close enough to the 9-period high — with a stop below the Kijun. Figure 7.3 shows this strategy in action.

Figure 7.3: **How to jump into an uptrend even after missing the initial set-up by using a pullback**

Strategy in a Bearish Trend

Wait for a pullback of the stock above the Tenkan. In many cases, the price will test the Kijun for resistance. If the supply is strong, the price will fall back and continue its downtrend. When price closes back below the Tenkan, place a sell order below the 9-period low — the 26-period low if both are close enough. The stop loss should be placed above the Kijun and trailed with it as it moves down with price. You can notice in the chart of Tata Steel in Figure 7.4 that one had two occasions to enter a short trade after missing the initial Kumo breakout trade.

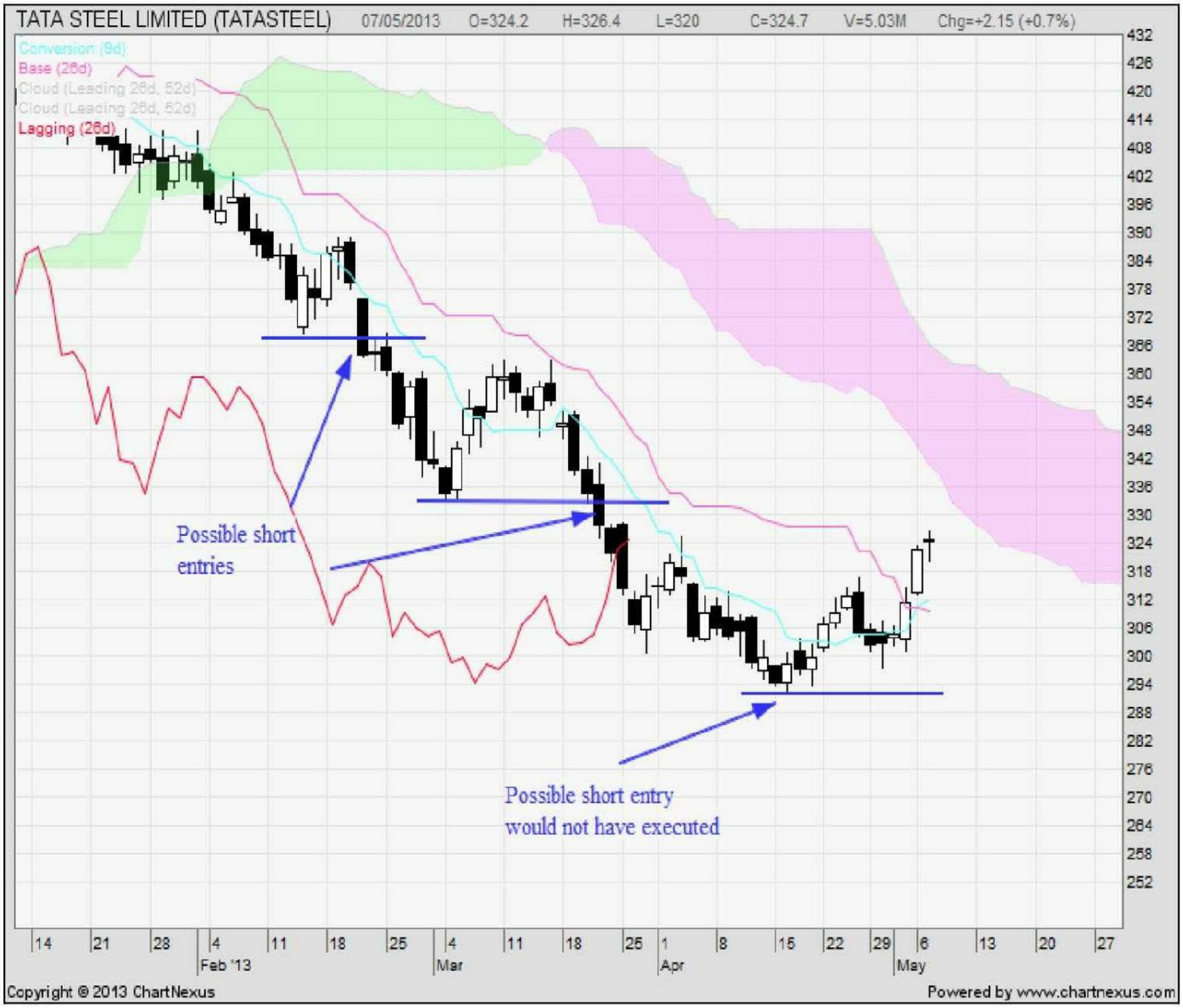

Figure 7.4: **Two possible entry opportunities to go short in Tata Steel during pullbacks**

The chart of Reliance Infrastructure in Figure 7.5 provides traders with two short entry possibilities after the initial Kumo break strategy. Keep in mind, however, that there will be instances where one enters the trade and the trend reverses. Having a stop loss in place assures, in most instances, that the loss will be minimal.

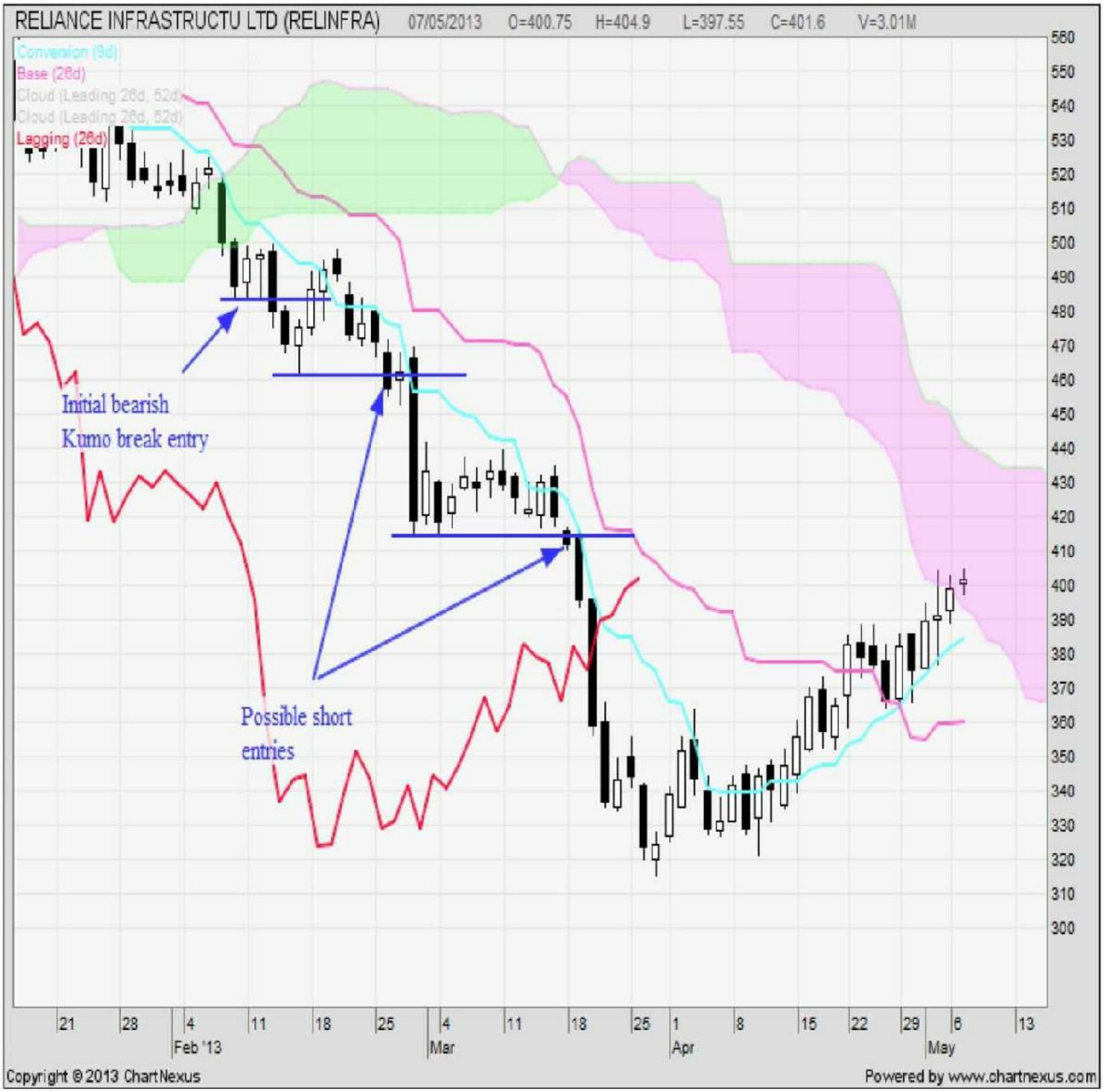

Figure 7.5: **Reliance Infrastructure provides good short entries during pullbacks even after the initial bearish Kumo break set-up**

Option Trading Strategies with the Ichimoku System

Option (a derivative) trading is a world of its own. **This section assumes that the reader is familiar with options. If not, I would strongly suggest that you first gain as much knowledge of options as possible before attempting their use in trading.** Options provide big leverage which can boost portfolio returns; or, on the flip side, ruin the trader.

Where simple option buying can help is on the short side. If a trader wants to take advantage of a bearish scenario, he can short the stock, short the futures in that stock or buy put options on that stock. In a falling market, it becomes difficult to borrow shares of a stock to short. Shorting futures presents an unlimited loss scenario if the stock reverses and starts heading up. Using put options, however, gives the trader limited risk with high return potential.

Here is the link to NSE’s web page detailing all the equities that have tradable options.

http://www.nseindia.com/products/content/derivatives/equities/fo_underlying_home.htm

Now, let’s consider the chart of Tata Motors in Figure 7.6.

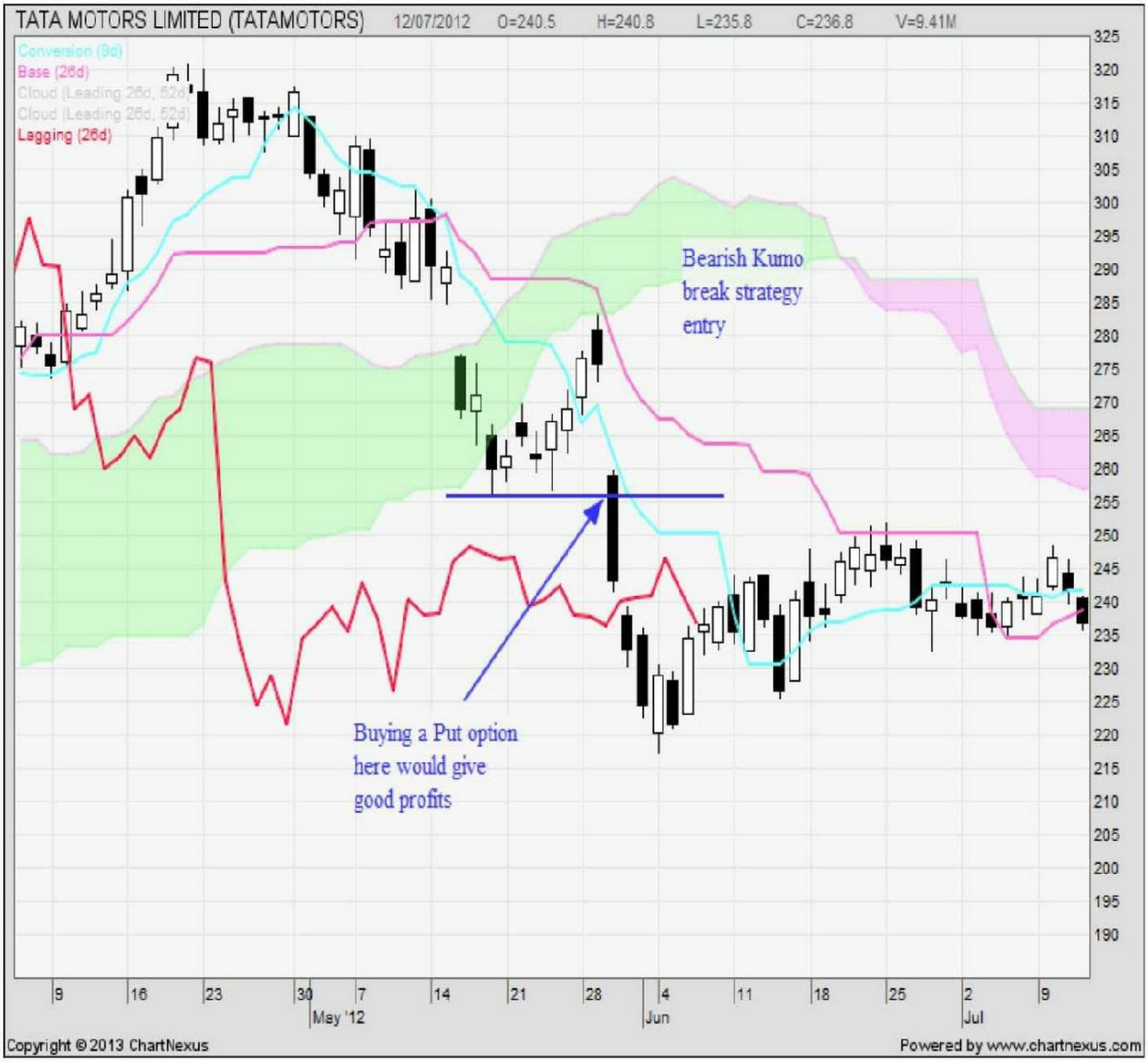

Figure 7.6: **Buying put options for short trading Tata Motors using the Kumo break strategy**

The idea would be to buy a put option when one of the Ichimoku strategies calls for a short entry. A deep in-the-money (ITM) Put option can mimic the movement of the underlying stock. In this case, one could have bought the June 270 Put option as the stock broke through the 9-period low. This ITM Put option would have increased in value as the stock moved down. Profit-taking rules remain the same. Profits should be taken on a continuous basis and the entire position should be exited when the price trades, or closes, above the Kijun.

Trading in the Direction of the Bigger Trend

‘The trend is your friend’ is a well known and powerful adage in financial markets. There is a good reason for it. Markets are based on human psychology. Once the investor sentiment establishes in a certain way, whether bullish or bearish, it takes time for it to change. In bullish trending markets, every dip is used as an opportunity to enter long positions. In strong bear markets, on the other hand, every rally is sold into. Doing the reverse could wipe out one’s portfolio in a hurry.

So how do you find the prevailing trend? To do that, look at the higher time frame Ichimoku chart.

Say, for example, one is looking to swing trade using daily time frame charts. The idea, then would be to look at the weekly chart for direction.

- If price is above the Kumo cloud on the weekly chart, then only bullish trades should be taken on the daily chart.
- Conversely, if price is below the Kumo cloud on the weekly chart, then take only bearish trades on the daily chart.

Let’s now consider the chart of Indusind Bank in Figure 7.7.

As you would note, there are two bearish Kumo break signals in March. Both the signals satisfy our Kumo break strategy for a short entry. In both cases, price was below the Tenkan, which was below the Kijun. The future Kumo was bearish and the Chikou was free. Both the trades would have lost money. Again, nothing wrong with having a losing trade. But, as we will see with the chart in Figure 7.8, this could be avoided.

Figure 7.7: **Daily chart of Indusind Bank indicating futures for short trades**

Next, notice the bearish T/K cross. Our strategy criteria for a short entry was met in this case. The trade would also have resulted in a loss. But now look at the bullish trade that should have been initiated on the Kumo break to the upside. This would have resulted in a nice rally for the trader. To see why the first three trades failed and the fourth succeeded, look at the weekly chart of the stock shown in Figure 7.8.

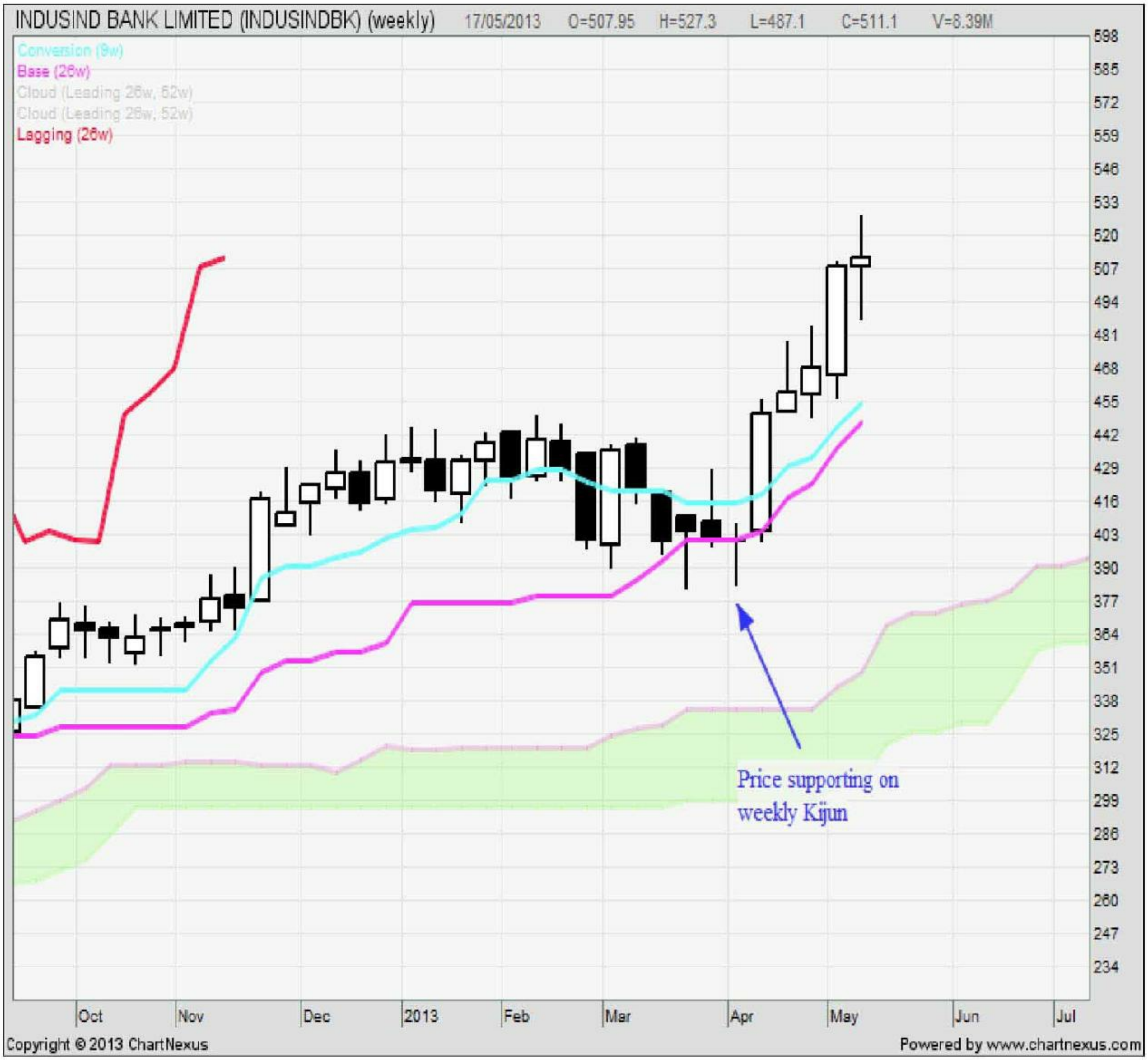

Figure 7.8: **Weekly chart of Indusind Bank clearly negates any short trades as the price was above the Kumo and also very close to the major support of weekly Kijun**

The chart is self-explanatory. There was no reason to take the short trades in this stock as not only was the price above the Kumo, but also very close to the major support of weekly Kijun. The bullish trade, however, was aligned with the bigger trend to the upside.

As another example, let's consider the daily chart of Indian Overseas Bank (IOB) in Figure 7.9. Indian Overseas Bank closed decisively above the Kumo on 30 December 2014. On 1 January, the continued up move also pulled the Tenkan above the Kijun. At this point, the future Kumo was bullish and Chikou was above the price indicating good upside momentum in the stock.

Figure 7.9: **Daily chart of Indian Overseas Bank suggesting long entry trades**

All conditions were satisfied for entering a long position using the Kumo break strategy. Things however did not work out for the trade and it had to be closed for a loss on 30 January as it closed below the Kumo.

Could this losing trade have been avoided? To answer this question with relative ease, look at the chart in Figure 7.10. This is a weekly chart of Indian Overseas Bank.

Figure 7.10: **Weekly chart of Indian Overseas Bank clearly shows strong resistance by the Kumo and the Kijun highlighting the futility of going long**

The weekly chart clearly shows strong resistance to the stock in terms of the Kumo and the Kijun. Where the daily chart showed a buy scenario, the weekly chart showed otherwise. Why enter positions when there is a conflict between the smaller and the higher time frame chart?

Having said that, there will be times when trading the bullish side on the daily chart while the weekly chart is bearish might lead to profitable trades. An example would be a stock trading below, or within, the Kumo, but above the Tenkan and Kijun on the weekly chart. If you notice a Kumo break on the daily chart, the trade can then be taken with stops in place. Just keep in mind that it will not be a high probability trade. The same would be true for a bearish trade based on the daily chart, when the weekly chart is bullish.

Take Partial Profits as They Accumulate

Throughout the book I have recommended that partial profits should be taken as the position moves in the desired direction and starts becoming profitable. One can employ a variety of profit taking strategies based on Western technical indicators like Fibonnaci retracements or pivot points. Some traders like to take profits at pre-determined price levels or percentage levels. Others will ride the original position until they are stopped out below / above a key moving average support. Ichimoku trading system offers a unique stop loss and profit-taking setup.

Ichimoku being a trend following system, the Tenkan and Kijun typically act as guides for the stock's price in the trending direction. The Tenkan can be considered a minor support level and the Kijun a major support level in case of a bullish trend. Correspondingly, the Tenkan acts as a minor resistance level and the Kijun acts as a major resistance level for down trending stocks. This trait can be used to form a system for placing stops.

We have already discussed using the Kijun as our initial stop loss point. Once a trade is initiated with a Kumo break or a T/K cross strategy, the price should not be violating the support (or resistance for a bearish trade) offered by the Kijun. As the price starts moving in the expected direction, the Kijun will begin trending with it. The initial stop can be moved up (or down for bearish trade) with the Kijun.

Profit-Taking Strategy for Bullish Trending Markets

Divide your trading position in three parts. Take one part off once the price closes below the Tenkan. At this point there are two things that can happen. Either the price keeps going down and closes below the Kijun, or the price reverses and closes back above the Tenkan, thus continuing its uptrend. In the first case, close out the remaining two parts of your position. In the second case, continue to hold the two parts until the next time the price closes below the Tenkan. At that point, you should take profits on one more part. Now you are left with just one part of the original position, which should be closed / stopped out below the Kijun.

Let's consider the chart of Syndicate Bank in Figure 7.11.

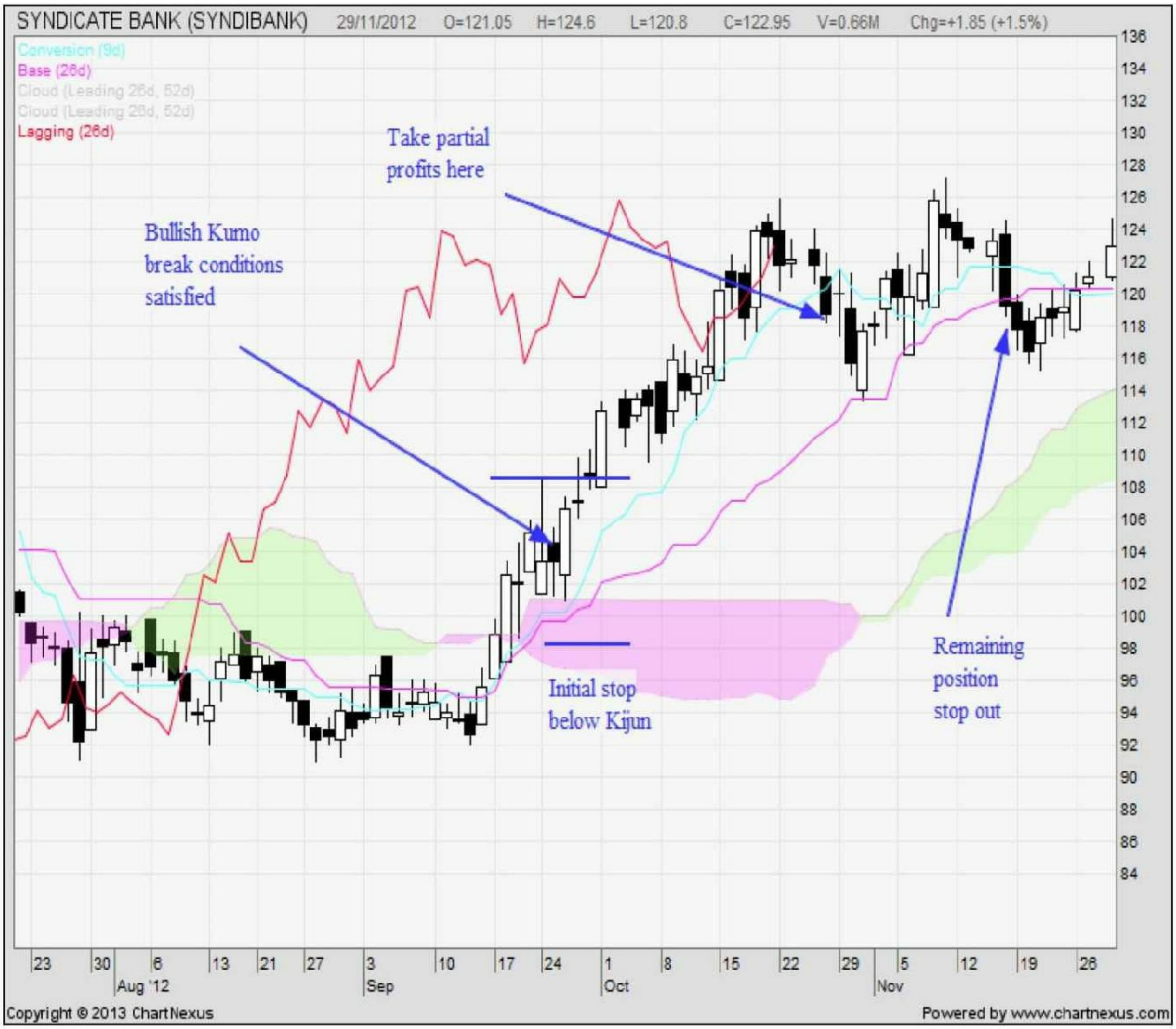

Figure 7.11: **Using the Tenkan for taking profits in a bullish trend**

Assume 300 shares were purchased at about ` 109 on 27 September following a bullish Kumo break. Using our exit strategy, 100 shares should be sold on 26 October for about ` 118.50. The remaining 200 shares should be liquidated on 16 November for about ` 119.

Profit-Taking Strategy for Bearish Trending Markets

Again, divide the position in three parts. Take one part off as the price closes above the Tenkan. At this point there are two things that can happen. Either the price keeps going up and closes above the Kijun, or the price reverses and closes back below the Tenkan, thus continuing its downtrend. In the first case, close out the remaining two parts of the position. In the second case, continue to hold the two parts until the next time the price closes above the Tenkan. At that point, take profits on one more part. Now you are left with just one part, namely one-third of the original position, which should be closed / stopped out above the Kijun.

Let's consider the profit taking strategy in the case of Reliance Capital whose chart is shown in Figure 7.12.

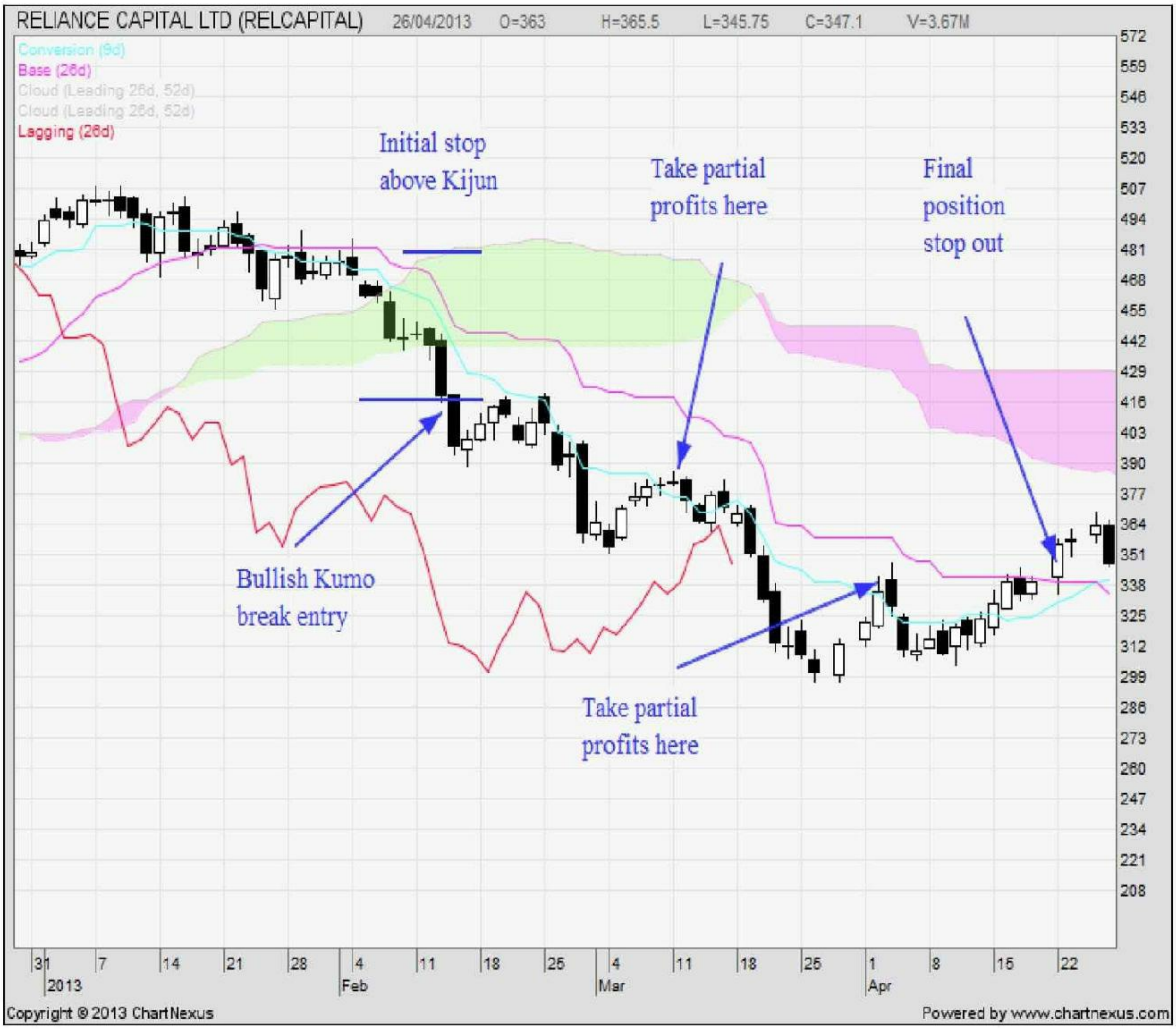

Figure 7.12: **Using the Kijun to take profits in Reliance Capital**

Assume 3 Put options were bought on 14 February on Reliance Capital with the stock trading at 415. On 11 March, the stock closed above the Tenkan at 382. This would be the trigger to close out 1 Put option. The stock then reversed and continued its downtrend. On 2 April, the price once again closed above the Tenkan at 335. This would be a trigger for liquidating another Put option. The remaining Put option would be closed on 22 April as the price closed above the Kijun at 355.

Position Sizing

Position sizing your trades is as critical to trading success as the trading system itself. Using random position sizes for trades is a recipe for disaster. Consider a trader who judges that trade A has better reward potential than trade B. With this belief, he invests more capital, taking on much more risk in trade A than in trade B. If trade A goes south and trade B does as expected, the trader might still be sitting on big overall losses. The trader will not survive in his trading career for long with this way of investing capital.

I often talk about position sizing in terms of maximum risk. Keep in mind that it is easy to handle profits. Not so for losses. So a strategy that accounts for fixed losses makes good sense for a high probability trading system like the Ichimoku.

Here is how you would implement the fixed loss position sizing strategy:

Scenario 1:

- Portfolio = ` 10 lakh
- Maximum risk % per position = 0.2 %
- Maximum risk for any position = 0.2 % x 10 lakh = ` 2,000
- Strategy = Bullish T/K cross
- Stock price = ` 100
- 9-period high = ` 101
- Entry point = ` 101.50
- Current Kijun price = ` 98
- Stop loss setting = ` 97.5
- Maximum loss = 101.5 – 97.5 = ` 4
- Total number of shares to be bought = Max risk tolerance / Maximum loss = 2,000/4 = 500
- Total capital for this position = 500 x 101.5 = ` 50,750.

Scenario 2:

- Portfolio = ` 10 lakh
- Maximum risk % per position = 0.2 %
- Maximum risk for any position = 0.2 % x 10 lakh = ` 2,000
- Strategy = Bullish T/K cross
- Stock price = ` 100
- 9-period high = ` 101
- Entry point = ` 101.5
- Current Kijun price = ` 96
- Stop loss setting = ` 95.5
- Maximum loss = 101.5 – 95.5 = ` 6
- Total number of shares to be bought = Max risk tolerance / Maximum loss = 2,000 ÷ 6 = 333
- Total capital for this position = 333 x 101.5 = ` 33,800.

Scenario 3:

- Portfolio = ` 10 lakh
- Maximum risk % per position = 0.2 %
- Maximum risk for any position = 0.2 % x 10 lakh = ` 2,000
- Strategy = Kumo Breakout
- Stock price = ` 100
- 9-period high = ` 101
- Entry point = ` 101.5
- Bottom of Kumo = ` 93
- Stop loss setting = ` 92.5
- Maximum loss = 101.5 – 92.5 = ` 9
- Total number of shares to be bought = Max risk tolerance / Maximum loss = 2,000 ÷ 9 = 222
- Total capital for this position = 222 x 101.5 = ` 22,533.

The three scenarios show how the quantity of shares bought changes with respect to the initial stop loss. If all the trades fail, the trader's maximum loss is capped at ` 2,000 each. Remember that if the Ichimoku strategy works and the stock goes in the direction as expected, the Kijun will move with it. The stop loss setting should be moved with the Kijun. So the maximum loss should only happen at the beginning of the trade. This, of course, assumes that some unexpected fundamental event does not gap the stock down beyond the stop setting.

This strategy allows the trader to be calm and confident when entering the trade as the maximum loss is both pre-defined and is one that the trader is comfortable with.

8

Conclusion

This is where the rubber meets the road. Knowing a system and using it in the proper context are two different things. There are plenty of traders who know ten different systems, but cannot implement even a single one. That‘s because they lack the confidence in their ability to actually profit from those systems. Keep in mind that the system is only a part of the trading equation. The trader’s psychology is equally important. It is completely possible for two traders to take the exact same system and come out on two opposite ends of the profit scale. Why the difference? The personality of the traders!

What Type of Trading is Right for You?

It would be worthwhile to address this question before you start trading. Here are three different ways to profit from the market and the basic personality traits suitable for each. Analyze where you fit in!

Day Trading

This is where you open and close positions during the day. The assets are not held overnight. You are using larger position sizes to make quick, small, multiple gains.

A day trader typically has the following personality traits:

- You are uncomfortable with the risk of holding assets overnight because fundamental news coming out after hours could disrupt your strategy.
- You are a quick thinker and decision maker.
- You have strong emotional control. This is extremely important as your emotions will be tested each and every minute you are in the trade.

Swing Trading

This is where you hold positions from a few days to a couple of weeks depending on the trend of the asset.

A swing trader typically has the following personality traits:

- You are comfortable with the risk of holding assets overnight. Your strategy takes into account any fundamental disruptions occurring after hours.
- You like to make entry / exit decisions in a relaxed state of mind. You might be working at a full-time job and need to make your call when you come home at night.
- You cannot handle the constant emotional ride during the day.

Long-term Trading (Investing)

This is where you hold positions for weeks to months at a time, typically using weekly charts.

Long term traders and investors usually have the following personality traits:

- You believe in the underlying fundamentals of the company you are investing in and are willing to give it more time to prove itself.
- You do not care about the day-to-day ups and downs of the market.
- Your ideal scenario is when an undervalued company exhibits good entry point on weekly charts.

So where do you fit in?

Once you have truthfully answered this question, you can proceed to choosing a strategy and making it your own. Keep in mind that losing trades will be a part of the game no matter what the style of trading is. Learn to handle them emotionally, and profitable trades will follow. Also, the market will throw one opportunity after the other at you. If you miss one, do not feel disappointed. There will be another one again tomorrow. Always keep your enthusiasm high and maintain a healthy positive expectancy of success.

Good luck — and happy wealth building.