TraderFeed

Exploiting the edge from historical market patterns

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Entering Markets on Pullbacks From a Trend: A Best Practice in Trading

Note From Brett: This best practice post comes from professional trader, fund manager, author, and educator Ray Barros. Since he started trading 20 years ago, his track record reflects a whopping 39 percent per annum return on a compounded basis. He is also the author of two books--*The Nature of Trends* and *The Ray Wave*. Ray has been regularly featured in regional newspapers and publications, including the *Sydney Morning Herald*, *Your Trading Edge Magazine*, *Business Times*, and *Smart Investor*. I've been in touch with Ray for a while now and can vouch for his experience, insight, and dedication to teaching. In this post, he generously shares one of his favorite trading setups. His basic method is to enter trends on pullbacks, relying on the structure of the setup to provide both entry and stop. This creates a nice risk:reward ratio and, in my book, merits acknowledgment as a best practice.

From Ray:

I am writing to introduce an idea that has been around since at least the days of Richard Wyckoff (1920). I have seen it in many different guises from Bruce Babcock's 'Slinky System' (http://www.rb-trading.com/bbbio.html) to Bradford Radsche's 'Turtle Soup' (http://www.lbrgroup.com/index.asp) to Joseph Hart's ‘Repo’ (http://www.trend-dynamics.com/). Nowadays, I use the word ‘RePo’ to identify the pattern.

I’ll describe the buy pattern; reverse the rules for a sell.The conditions for a buy are:

- Identify an uptrend in the timeframe you are trading.
- Identify a correction to that trend.
- Within that correction, identify a swing low (A).Following ‘A’, there will be a rally to a swing high (B).That rally is followed by a new low (C).

  My research shows that it is best if ‘C’ is within 20% of the ‘AB’ range. For example if the AB range is 20 points, and ‘A’ is 1404, then it is best if ‘C’ is no lower than 1400.

  The calculations are: 1404 (which is A’s low) – 4 (which is 20% of the AB range of 20) = 1400. [corrected- BNS]

  While it is best that ‘C’ be within 20% of AB, it need not be. **But, it is essential there be no close below the 20%.**

- After ‘C’, the market reverses the down move and closes above ‘A”.This bar (D) must show buying conviction.In my own trading, a bar that shows buying conviction takes one of two forms:

  - a bar that opens no higher than in the bottom third of its daily range and closes no lower than the top third of its daily range.I call this a bull bar will stop
  - a bar that opens no higher than in the bottom 25% of its daily range and closes no lower than in the top 25% of its daily range.I call this a directional bar up.

The keys to this setup are

1. the identification of the trader's Timeframe trend and
2. the ability to define a corrective move.

The best tools I know to do this are Swing Charts. I like swing charts because they give a clear visual picture of the trend and they give earlier warnings of a change in the trend.

There are at least two types of swing charts:

1. Arthur Merrill's 'Filtered Waves'.These are the most popular.(If you are an E - signal user, Jan Arps offers a free utility, Universal Swing Analysis Tool (UST), at:

   http://www.janarps.com/

   (select free download).

   The utility probably draws percentage charts. I say seem because the logic is not disclosed.

2. The other type of charts by timing price based: Hart Swing Charts and Barros Swing Charts (http://www.tradingsuccess.com/ .These differ from percentage swing charts because they use both time and price inputs to draw the charts.

   The question I am usually asked is: does it matter what type of swing construction you use?Not really, *provided* about the same magnitude swings are compared.

From Brett: Notice what makes this setup powerful. You're going in the direction of the longer timeframe trend, waiting for a pullback, but then requiring that the market begin to reestablish this trend before you enter. By definition, this method will not have you trying to guess price highs and lows. Rather, you'll wait for the market to make an apparent high or low and then enter when you get a bar moving convincingly in the opposite direction. My strong suspicion is that this setup could work on multiple timeframes, including intraday. Many thanks to Ray for his generous sharing of an idea that has contributed to his success.

Posted by Brett Steenbarger, Ph.D. at 1:15 PM

5 comments:

Deborah said...

Interesting. I tend to look for pullbacks in the stocks I buy, but that just simply identifies stocks for me to further research.

Then I check out the fundamentals looking for a reason for the pullback.

I probably buy a lot of stocks that are over sold because of fear selling, and it works wonderfully to make a very good short term (under 3 months) return.

makingsenseofmyworld.blogspot.com/

12:05 AM

CHLuke said...

I'm also a big believer in this type of setup; I'm most familiar with Dave Landry's "version", which he also readily admits is nothing new. I am a bit concerned, though, that Mr. Barros stresses a specific percent, in a system he's intimately familiar with, and yet had the numbers wrong. 2 points of a range of 20 is 10%; 20% (needless to say, or so I thought) is 4 points. Nevertheless, thanks so much for the fantastic blog, Brett. Learning much from you continually.

12:37 AM

cbaer said...

Great post,
I have as well noticed that a rebound
after such a setup can be very violent,
or the way Brett says it:
'A strong trend day'

With respect to chluke's comment I
have often noticed that when people
are really into something, they cannot imagine how others do not readily understand what they are saying.

It could be that the 20% which is obviously 4 for a 20 point range is a mistake. But I prefer interpreting it another way:

I would consider a range around the old low at 1404 from 1402 - 1406. Why because if the new low is above 1404 it is an even better setup. So if I am interpreting it right you can use values below 1402 for your stop loss.

Am I right?

I guess deborah that if you are dealing with a timeframe of month fundamentals do play an important role.
Probably if you have a shorter time frame in a strong trend let us say 10 days and less (how short can you go with this setup?) fundamentals probably do not have changed much in most occasions.

Great idea.

8:33 AM

Brett Steenbarger, Ph.D. said...

Hi All,

Thanks for the great comments. I do think there's a very interesting issue identified by Deborah and Cbaer: What is the minimum timeframe at which fundamentals become important for framing trade ideas? Trading economic releases makes fundamentals relevant for even short-term traders, and analyzing intermarket relationships (among currency crosses, with fixed income markets, etc) and economic data is certainly important to a swing trader. How to integrate fundamental understanding into shorter time frame trading would be a wonderful topic for a "best practice" post.
Thanks--

Brett

9:13 AM

Brett Steenbarger, Ph.D. said...

Hello Readers,

Ray just emailed me with a correction to his article:

"Frankly I just made a mistake in the example in the text. The price ought to have been 1400 since 20% of 20 points is 4 not 2 points.

That error aside the concepts are

correctly stated.

This is why I setup my charting package to automatically calculate the 20%.
This way I don't make any silly mistakes like I did
in the contribution.

Sorry for the error and confusion."

Thanks, Ray, for the correction.

Brett

9:20 AM

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